

**LEHMAN BROTHERS, SHARPER IMAGE, BENNI-  
GAN'S AND BEYOND: IS CHAPTER 11 BANK-  
RUPTCY WORKING?**

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON  
COMMERCIAL AND ADMINISTRATIVE LAW  
OF THE  
COMMITTEE ON THE JUDICIARY  
HOUSE OF REPRESENTATIVES  
ONE HUNDRED TENTH CONGRESS  
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## **LEHMAN BROTHERS, SHARPER IMAGE, BEN- NIGAN'S AND BEYOND: IS CHAPTER 11 BANKRUPTCY WORKING?**

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**FRIDAY, SEPTEMBER 26, 2008**

HOUSE OF REPRESENTATIVES,  
SUBCOMMITTEE ON COMMERCIAL  
AND ADMINISTRATIVE LAW,  
COMMITTEE ON THE JUDICIARY,  
*Washington, DC.*

The Subcommittee met, pursuant to notice, at 10:26 a.m., in room 2141, Rayburn House Office Building, the Honorable Linda T. Sánchez (Chairwoman of the Subcommittee) presiding.

Present: Representatives Sánchez, Lofgren, Delahunt, and Cannon.

Staff Present: Eric Tamarkin, Majority Counsel; Adam Russell, Majority Professional Staff Member; and Stewart Jeffries, Minority Counsel.

Ms. SÁNCHEZ. This hearing of the Committee on the Judiciary, Subcommittee on Commercial and Administrative Law, will now come to order. You guys can be seated. Without objection, the Chair will be authorized to declare a recess of the hearing. And I will now recognize myself for a short statement.

Today we find our country in the midst of the most significant economic crisis of our Nation's history, perhaps since the 1929 depression. The subprime mortgage meltdown and housing market collapse have sent shock waves throughout all of the sectors in the United States economy and threaten the global economy.

The cascading effect of tightened credit has led to unprecedented government bailouts of private companies and a surge in business bankruptcies. According to the American Bankruptcy Institute, during the first half of 2008, there have been 55 percent more Chapter 7 liquidations than last year. Chapter 11 filings, where a company attempts to stay in business, are up 30 percent.

Last week, Lehman Brothers filed for bankruptcy under Chapter 11, with total debts of \$613 billion against total assets of \$639 billion. This filing is the largest in U.S. history, dwarfing the previous largest bankruptcy in 2002 of WorldCom Incorporated, which had \$104 billion in assets. Although Lehman racked up huge losses in risky mortgage-backed securities that could undoubtedly have had a major impact on the market, the Federal Government refused to bail it out and, as a result, Lehman filed for bankruptcy.

On the eve of Lehman's bankruptcy filing, it apparently utilized the netting provisions of the 2005 Bankruptcy Code Amendments to offset various financial contracts it had outstanding. Accordingly, I hope at least some of the witnesses will help us understand the ramifications of these netting provisions as a matter of bankruptcy policy.

Other large financial institutions have found themselves in similar positions recently. Earlier this year, California-based IndyMac filed for liquidation under Chapter 7 of the Bankruptcy Code, making it the ninth largest bankruptcy in history. IndyMac was crippled when the housing crash and ensuing economic slump caused borrowers to default on their loans and depositors to pull their money out of the bank at the same time.

Chapter 11 bankruptcy filings have not only become more prevalent in the financial sector, but they have been on the rise among retailers. Sharper Image, Levitz and Bennigan's are just a few of the household names that have recently sought to reorganize under Chapter 11. A disturbing trend that appears to be developing is that more and more retailers are opting to liquidate rather than to reorganize. Some blame the overall economic climate. Some blame the credit crunch.

Those in the bankruptcy community believe that the 2005 amendments, including, for example, the nonresidential leasehold provision, are the principal cause of retailers choosing to close their stores, lay off their employees, and liquidate their assets rather than to attempt to reorganize.

The purpose of today's hearing is to examine whether Chapter 11 is working as Congress intended and whether the amendments to the Bankruptcy Code in 2005 have made it more difficult for business debtors to reorganize.

We will also review how the increase in business bankruptcy fits in the current economic crisis that has engulfed our country.

I should note that Judiciary Committee Chairman Conyers invited a representative from Lehman Brothers to participate in this hearing for the purpose of explaining the circumstances leading to the filing of its bankruptcy case and how the financial contract offsets will impact its bankruptcy case. Unfortunately, Richard Fuld, Jr., Chairman and Chief Executive Officer of Lehman, was not able to make himself available, even though we offered to have him participate via video conference. Given the significance of the issues presented by this hearing, I may suggest that we will conduct a further hearing at which Mr. Fuld will have an opportunity to testify.

As this is our last scheduled hearing, I wanted to take this opportunity to thank all of the Members of the Subcommittee in our work during this Congress. It has been a busy 2 years, far busier for this Subcommittee than I think most would have imagined at the beginning of the term. So I am especially thankful to everyone for their hard work, including the staff.

I particularly want to salute our Ranking Member, Mr. Cannon, and to wish him my very best in his future endeavors. Congressman Cannon has been a fearless leader in working to reauthorize the Administrative Conference of the United States, a highly respected administrative law and process think-tank that provided

valuable guidance to Congress and the executive branch. Even in an area that has often been contentious, bankruptcy reform, Mr. Cannon was willing to work with us across the aisle on significant issues, including consideration of ways to address excessive executive compensation in Chapter 11 bankruptcy cases.

Mr. Cannon, I want to thank you for your service to the Subcommittee on Commercial and Administrative Law as both the Chair and Ranking Member, and as a distinguished Member on the full Committee, as well as a well respected Member of Congress in other areas. We are very sorry that you will be leaving Congress, but I know that you are going to go on to accomplish wonderful things, and we wish you well.

Ms. LOFGREN. Will the gentlelady yield?

Ms. SÁNCHEZ. I would yield.

Ms. LOFGREN. If I may, I would just like to also note the tremendous service that Congressman Cannon has given to our country in his years in the House. It has been a pleasure to work with him. We don't agree 100 percent on things, but he is a smart person and he is an honest person and he is someone who can talk through things without a bunch of games or hidden agendas, just to try and get something done for the American people.

So it has really been an honor for me to work with him on many issues. And he is a credit to his district and his State. And I will miss him tremendously next year as a Member of Congress. And I thank the gentlelady for yielding.

Mr. DELAHUNT. Would the gentlelady continue to yield?

Ms. SÁNCHEZ. I would yield to the gentleman from Massachusetts.

Mr. DELAHUNT. Because I want to echo your sentiments and that of Ms. Lofgren's. I have had an opportunity to work with Chris on a number of issues. He is a straight shooter, he has a keen intellect, he has a passion for public policy and he is just a great guy. And he will be sorely missed. And it should be noted that he commands great respect on the Democratic side of the aisle, and we all wish you the very best, Chris.

Ms. SÁNCHEZ. I think it is unanimous. We love you, Mr. Cannon, and are sorry to see you go.

At this time, it is my pleasure to recognize my distinguished colleague, Mr. Cannon, the Ranking Member of the Subcommittee for his opening remarks.

Mr. CANNON. I thank the Chair and ask unanimous consent to have my written statement included in the record.

Ms. SÁNCHEZ. Without objection, so ordered.

Mr. CANNON. Have you guys been campaigning for me in my district? I would like the record to reflect that I have one of the most conservative voting records in Congress. But that said, I do have many dear friendships in this body. There are many people that I will miss.

Bill Delahunt and I came together. I think he had only been here a little while before I got here. The three of us have worked together for many years on issues that I think are very important.

And it has been a pleasure to have our new Chair, Ms. Sánchez, take the Committee. We work sometimes at odds and sometimes together, but mostly—this is the coolest Subcommittee on Earth be-

cause the issues are really important and they are arcane and people don't get them and don't understand them generally. So the arguments are sort of in-house. But I have been a big promoter of the jurisdiction of this Committee, and the new Chair also has been a promoter of the jurisdiction of this Committee.

I think I am going to make one last statement about that. We have jurisdiction over the way the Federal Government oversees commerce and that, by nature, just includes administrative law. So this Committee ought to be reviewing—and I hope we pass early next year the bill that we have introduced that will give this Committee jurisdiction over all regulations for review. And then, ultimately, I would hope that this Committee gets the authority to take regulations to the floor of the House to be voted on before they become law and thereby recapturing the legislative role that we have delegated away I think, unfortunately, to the executive branch.

And secondly, we are evolving as a Nation and I don't think that this has been understood or recognized. We have thousands of organizations that should be interstate compacts but aren't because they don't understand that they need congressional ratification.

The other side to that is that to the degree that we can move Federal activities to interstate compacts, I believe in many ways the country is going to be better off. I don't think anybody believes that FEMA has performed well, ever. It is an amazing concentration of power. The Senate reviewed what happened after Katrina and basically said we shouldn't have a Federal Emergency Management Agency. What did work were the interstate compacts, the compact between Louisiana and Texas and other States in that region that allowed, on the statement by the Governor, that there was an emergency that allowed Texas troopers to cross the border into Louisiana and help perform the police functions, as had been anticipated by that interstate compact.

So this is a great Committee, one that I have loved being on, one that I hope the people that remain on the Committee will continue to work toward expanding the jurisdiction of. And let me just say that it has been a pleasure to work with all of you on many different issues. You said all kind things about me. Those things are things that you are saying because those traits are inherent to each of the three of you, and it has been a pleasure for me to work with you. And I don't intend to disappear. At least the Chair has pointed out that I have some kind of future, and I appreciate the fact that she thinks it will be bright. I intend to make it bright. And I will miss this Committee and Congress.

And thank you and I yield back the balance of my time.

Ms. SÁNCHEZ. I thank the gentleman. I'm sure we will be hearing much more from you, Mr. Cannon, and hope you will remain available for us to pick your brain next year in the next session when we work on some of these issues that you have raised.

[The prepared statement of Mr. Cannon follows:]

PREPARED STATEMENT OF THE HONORABLE CHRIS CANNON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF UTAH, AND RANKING MEMBER, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

Thank you for calling this hearing on Chapter 11 bankruptcy. As Chairman Conyers is fond of pointing out, this "sleepy Subcommittee Number 5" has been very



busy these last two years. And bankruptcy has been one of our busiest areas. According to my count, we have held no less than 10 prior hearings on bankruptcy related topics—including two other hearings on Chapter 11 bankruptcy.

That is, I think, appropriate given the importance of bankruptcy as a means of addressing debt in this country. In fact, the Founders thought it so important that they explicitly listed it as one of the enumerated powers of Congress in Article I, section 8 of the Constitution. Given that Congress passed a major overhaul of the bankruptcy laws in 2005, it perhaps not surprising that it would take a hard look at that law in this Congress to see how it is performing. Of course, the current financial difficulties facing this country also make bankruptcy an unfortunately all too relevant of a topic.

The hearings that we have had on bankruptcy have been illuminating—some perhaps unintentionally so. Whenever a major piece of legislation passes Congress, it inevitably involves compromises from all parties. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 is no exception. What we have seen with these hearings are that many of the parties involved in the 2005 bankruptcy bill have come back to try and strike a better bargain for themselves now that the political power on the Hill has shifted from Republicans to Democrats. That is inevitable, but it is also unfortunate.

Which brings us to today's hearing. The title of the hearing mentions Lehman Brothers, which is certainly one of the most famous—or perhaps infamous—bankruptcies of our times. Unfortunately, there is no one here to testify from Lehman Brothers, so I doubt that this hearing will shed much light on that subject.

What I do expect it to highlight is the complaints of some retailers with respect to changes in the treatment of leases. Prior to 2005, retailers could enter into Chapter 11 bankruptcy and, for all intents and purposes, refuse to make decisions about the future of their commercial leases for months and even years. This left shopping mall owners without any real way to locate new tenants for their malls. This hurt not only the owners of the mall, but also the other tenants that suffered from lower foot traffic due to closed stores. The changes to the bankruptcy code enacted in 2005 prevent a bankrupt tenant from tying up that property for years.

We will also hear about the overall mix of Chapter 11 reorganizations versus Chapter 7 liquidations. I am particularly interested to hear how that mix has changed over time, including trends that began before the changes of 2005. I am also curious what our witnesses have to say about the effects of the current economy—namely diminished consumer confidence and tightening credit—on the overall number of retail liquidations. I suspect that those factors may impact why companies choose liquidation rather than reorganization far more than any changes to the bankruptcy code.

Finally, I know that this Congress will not implement any changes to Chapter 11. That will be the work of future Congresses. However, I hope that those future Congresses will take into account the positive changes that we made in 2005 and not just throw out the proverbial baby because of the rough economic times that we are now facing.

I yield back the balance of my time.

Ms. SÁNCHEZ. I am now pleased to introduce the witnesses on our panel for today's hearing. Our first witness is Jay Westbrook, one of the Nation's most distinguished scholars in the field of bankruptcy and a part of the University of Texas Law School faculty. Professor Westbrook has been a pioneer in two respects: empirical research and international comparative studies of bankruptcy. Professor Westbrook also teaches and writes in commercial law and international business litigation. He practiced in all of these areas for more than a decade with Surri & Morris, now part of Jones Day in Washington, D.C., where he was a partner before joining the University of Texas Law School faculty in 1980.

Professor Westbrook is co-author of *The Law of Debtors and Creditors: As We Forgive Our Debtors*, *Bankruptcy and Consumer Credit in America*, and *the Fragile Middle Class*. He has been a visiting professor at Harvard Law School and the University of London and is a member of the American Law Institute, the National Bankruptcy Conference and the American College of Bankruptcy. I want to welcome you today.

Our second witness is Barry Adler. Professor Adler is the Charles Seligson Professor of Law at New York University School of Law, and has just completed a term as Vice Dean. He joined the New York University School of Law faculty in 1996, leaving his position as the Sullivan and Cromwell Research Professor of Law at the University of Virginia.

Professor Adler's course offerings have included bankruptcy, commercial law, contracts, corporate finance, and corporations. Professor Adler has written numerous articles on the application of corporate finance theory to issues of corporate insolvency. These articles suggest that bankruptcy law can be properly understood as an integral part of contract, property and tort law, rather than as a mere supplemental body of law applied after a financial failure. He is currently at work on a book, *The Law of Last Resort*, which will elaborate on this theme.

In addition, Professor Adler is the editor of the recently published reader: *Foundations of Bankruptcy Law*. Beyond his bankruptcy scholarship, Professor Adler has been published and continues to write in the fields of contract and corporate law. I want to welcome you as well.

Our final witness is Lawrence Gottlieb. Mr. Gottlieb is the Chair of Bankruptcy and Restructuring Practice and a member of the Cooley Godward—did I pronounce that correctly—Kronish, LLP's management committee. Mr. Gottlieb practices in the field of creditors' rights, bankruptcies and workouts. He has represented debtors in committees and Chapter 11 reorganizations, out-of-court workouts and other insolvency proceedings in over 40 States and Canada as well. He has handled matters involving a broad array of businesses including retail apparel, luggage, software, furniture, sporting goods, telecom, tools, drug, construction, foodstuffs and giftware.

Over the years, Mr. Gottlieb has represented creditors' committees and numerous Chapter 11 cases and frequently represents purchasers of assets and claims in bankruptcy. He regularly addresses creditor groups, corporate credit departments, credit associations, and other professional groups regarding creditors' rights and bankruptcy matters. I want to welcome you to our panel as well.

I want to thank you all for participating in today's hearings. Without objection, your witness statements are going to be placed into the record and we are going to ask that you limit your oral testimony today to 5 minutes. We have a lighting system that, when we remember to employ it, will give you the green light when your time begins. When you have a minute of testimony remaining, you will get the yellow warning light. And then when your time has expired, you will get the red light. At that time we would ask, if you are caught midsentence or midthought, we will ask you to finish that sentence or thought and then we will move onto the next witness. After all of the witnesses have presented their testimony, Members will be permitted to ask questions subject to the 5-minute limit.

So with that, I am anxious to get underway because we are expecting another series of votes.

Professor Westbrook, if you would begin your testimony at this time.

**TESTIMONY OF JAY WESTBROOK, ESQ., PROFESSOR,  
UNIVERSITY OF TEXAS SCHOOL OF LAW, AUSTIN, TX**

Mr. WESTBROOK. Good morning.

Ms. SÁNCHEZ. Can you please turn your microphone on? And you might want to move it closer to you as well.

Mr. WESTBROOK. How about that?

Ms. SÁNCHEZ. Much better.

Mr. WESTBROOK. Good morning. And thank you so much for asking me here to talk about this subject of exemptions of certain kinds of financial assets from bankruptcy law and bankruptcy court control.

We come together today in the midst of a hurricane, and I am just going to talk about one particularly large hole in the roof, which is this set of exemptions for financial assets. I particularly want to focus on the 2005 amendments which greatly expanded the scope of these exemptions and, in my view, made them seriously—raise a serious question about the efficacy of Chapter 11 reorganization for many companies in light of that expansion.

The 2005 amendments added to the list of financial assets, precisely the kinds of assets that are at the absolute center of the current crisis. It added mortgages, greatly expanded the coverage of derivatives and swaps, and it greatly expanded the possibility of netting values among all of those. All of those things have to be considered together because they are very much an integrated package of exemptions.

Prior to 2005 we had exemptions for financial assets, but they were narrow exemptions and they were focused on fairly specialized, exotic kinds of assets like swap agreements, true swap agreements. And as a result, they were focused on fairly narrow and specialized markets. I think the best example is repurchase agreements or repos. Before 2005, the only exempted area—excuse me—the only exempted area was for repurchase agreements relating to government securities or government-backed securities.

All of a sudden in 2005, at a time when Congress was focused primarily on consumer provisions of various sorts, we had an expansion of this exemption of repo agreements to include agreements—any agreement involving mortgages or mortgage-backed securities. These are essentially secured loans that were suddenly exempted from the automatic stay, the preference provisions, and the other aspects of bankruptcy control at the moment when a debtor files bankruptcy. Without that control, the bankruptcy laws can't function effectively and the debtor finds itself with many of its most valuable assets walking out the door at the moment bankruptcy is filed.

It also must discourage the filing of bankruptcy cases when the debtor really needs relief and when creditors need the orderly procedures that bankruptcy offers, because the debtor knows that these assets will disappear shortly before or shortly after the bankruptcy is filed.

One example has to do with a company that might have valuable contracts. It is important to understand, as I know the Members

of this Subcommittee do, that we have a lot of new creatures out there that aren't financial institutions, but hold a lot of financial assets. That is a big change, really, in our financial system. Hedge funds are the most common example, but there are many others.

So you may have a company that is in financial trouble and nonetheless has a number of profitable contracts which the bankruptcy rules would normally protect and make sure they can't simply be terminated by the other party, but those contracts can be maintained and the value in those contracts can be preserved if they turned out to be good bargains for the debtor. That is an extremely important part of the reorganization process. It is one of the reasons our reorganization works and reorganizations in many other countries do not work because they don't have that feature.

Unfortunately, the 2005 amendments not only expanded the scope of the exemptions but it made them much fuzzier, much more ambiguous than they had been before, so that now it is not clear exactly what a swap agreement is for this purpose; for example, to be exempted from these provisions and to be subject to the master netting provisions.

I saw back in 2000—Enron, for example, loved to make ordinary contracts in the form of swap agreements, did it all the time. And I am told by my friends on Wall Street and elsewhere that more and more lawyers, since the 2005 amendments, are recasting contracts that are not really financial contracts in the normal sense and swap agreements or as derivative contracts so that they can enjoy the benefits of this exemption.

Essentially what I want to ask the Committee to consider as a short-term solution is to roll back the 2005 amendments to return to where we were. Not to eliminate the exemptions completely, because there is a case to be made for the narrow exemptions that previously existed, but to roll back the exemptions that were adopted in 2005. I can't offer you so many hard examples or hard data. I wish I could because we are in the first crisis that we have had since the 2005 amendments went into effect. So some might counsel let's wait and see what happens. I personally think that in the current crisis it is not a good idea to conduct a natural experiment on our business community to see how many of them can survive in light of these exemptions, among other difficulties. This is, of course, not the only problem.

Thank you very much for letting me come and talk to you about these questions.

Ms. SÁNCHEZ. Thank you, Professor Westbrook. We appreciate your testimony.

[The prepared statement of Mr. Westbrook follows:]

PREPARED STATEMENT OF JAY WESTBROOK

THE UNIVERSITY OF TEXAS SCHOOL OF LAW  
AUSTIN, TEXAS

Testimony of  
Jay Lawrence Westbrook  
Benno C. Schmidt Chair of Business Law

Before the  
Subcommittee on Commercial and Administrative Law  
Committee on the Judiciary  
House of Representatives

September 26, 2008

## **Exemption of Financial Assets From Bankruptcy**

Thank you for the opportunity to talk with you about the exemption of large pools of financial assets from the bankruptcy process.<sup>1</sup> These exemptions are often claimed to be necessary to the accomplishment of certain transactions, but as a prominent Wall Street lawyer put it to me: “If the prospect of bankruptcy makes the deal too risky, it’s too risky a deal to do.” That is especially true for financial institutions and should be doubly true for those “too big to fail.”

I want to share with you today the following major points:

1. The 2005 amendments to the Bankruptcy Code greatly expanded the scope of the exemption of financial assets from the control of the bankruptcy laws.
2. The expansion included exempting for the first time mortgages and mortgage securities, the epicenter of the current financial earthquake.
3. The amendments also used ambiguous language that blurred the boundary between financial contracts and other contracts, creating a lack of predictability and an opportunity for abuse.
4. These exemptions considerably reduce the capacity of the bankruptcy laws, both liquidation and reorganization, to do their traditional work of ensuring an orderly, predictable, and fair resolution of financial distress.
5. The 2005 expansion could be undone without substantial difficulty. Prospectively, business could easily adjust.

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<sup>1</sup> I appear as a student of bankruptcy law, not as a representative of the University of Texas School of Law.

6. Given the highly unusual circumstances of systemic risk now presented, even a retrospective suspension of those exemptions could be made a condition of government aid where appropriate.

1. Background

A number of recent events, including the bankruptcy of Lehman Brothers last week,<sup>2</sup> have brought into question the broad exemption of financial assets from the control of the bankruptcy laws. I have been asked to address the effects of these exemptions on the efficacy of our bankruptcy system, especially Chapter 11 reorganization. Because the Committee was able to give me only short notice of the need for my testimony, these remarks are necessarily a short summary of a large and complex topic.

The essence of any bankruptcy law is control of the debtor's property by a court or other public body.<sup>3</sup> In our system, the control is exercised by a bankruptcy judge, who is typically a lawyer with a substantial commercial and business background and who is available pretty much any hour of the day or night for a true business emergency. The public control that accompanies a bankruptcy filing has two primary purposes: maximization of the value available for distribution to stakeholders; and the establishment of the rules for sharing in an orderly distribution of the value thus obtained. The most important stakeholders are creditors, although employees and others also have significant interests that bankruptcy laws seek to serve. The bankruptcy rules in any society reflect the policy decisions that legislators have made about the justice and economic efficiency of various possible approaches to maximizing value and the fair distribution of that value.

In all bankruptcy systems, the debtor's property is taken away from its control. Even in the United States, the Debtor in Possession (DIP), exercises control in a transparent atmosphere under the ultimate control of the bankruptcy court. The court in turn takes account of the views of a creditors committee and other interested parties. The automatic stay freezes the debtor's property pending further order of the court and the

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<sup>2</sup> There are very few reliable data so far available from the Lehman bankruptcy and other very recent events, which means my comments are more general and conceptual than they would be under other circumstances.

<sup>3</sup> Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 Tex. L. Rev. 795, 799 (2004)

avoiding powers make sure that improper or unfair transfers prior to bankruptcy are returned for distribution as Congress has commanded. In addition, certain special rules protect asset values. For example, the Bankruptcy Code makes unenforceable “ipso facto” clauses that permit contracts to be terminated upon bankruptcy, ensuring that all stakeholders can share in the benefits of any good bargains the debtor was able to strike before bankruptcy.

It is the natural desire of every creditor to be the one creditor that is not bound by these bankruptcy rules. If every other creditor is bound by legal cables to a public procedure, the one creditor exempted from that constraint will enjoy far better returns than everyone else. Because financial default is always injurious, each creditor has a truly sad story to tell and thus a truly appealing case for being exempted. Those lucky enough to succeed in winning an exemption do very well indeed, while the rest suffer much more than they would have done if every creditor had to share the pain.

All this is background to the subject of the exemption of financial assets from most of the key provisions of the Bankruptcy Code. These exemptions permit certain parties to avoid the effects of the automatic stay, the avoiding powers, and the ipso facto provisions so they can grab the value from what would otherwise be the debtor’s property available for sharing according to the Congressional bankruptcy scheme. These exemptions were granted originally in a much narrower form than they now have. They were sought on the theory that certain relatively esoteric markets were so international in nature and so removed from ordinary commerce that they required bankruptcy exemption to function properly and would not interfere in the ordinary functioning of the bankruptcy laws. Without revisiting the rationale in a serious or detailed way, Congress agreed in 2005, in a debate focused overwhelmingly on consumer bankruptcy provisions, to expand dramatically the scope and effect of these exemptions, covering far more types of transactions and products than before under provisions written with a wide and fuzzy pen. The resulting language could be read to include much that was not specifically contemplated by those who voted for the changes. The attached articles by Professor Edward Morrison, Joerg Riege, and Franklin R. Edwards, give background and provide detail as to the provisions. The details of the changes made by the 2005 amendments to

the Bankruptcy Code are described in the attached article by a team of lawyers from Cleary Gottlieb in a Practising Law Institute (PLI) paper.

## II. Nature of Exemptions

The financial assets exempted from bankruptcy control are securities and commodity contracts, repurchase agreements (“repos”), swap agreements (“swaps”), and netting agreements. The exemptions are found in sections 555-556 and 559-561 of the Bankruptcy Code. I will note briefly the nature of each product, but the reader is referred to an attached article by Professor Henry Hu for a more detailed explanation of derivatives. Although the article was written in 1993, the explanation is remarkably clear and will be helpful.

Repos are agreements by which a seller (debtor) agrees to sell (give a security interest in) certain securities or mortgages to a buyer (lender), with the seller obligated to repurchase them in a short time for a somewhat larger amount (interest and fee). In short, repos are secured loans in the form of sale and repurchase contracts. Prior to the 2005 amendments, the exempted repos were United States government or government-backed securities traded primarily in a specialized financial market. The amendments added most types of mortgages and mortgage-related securities to the list without regard to any connection with government. These are the very types of investments that have proved to be toxic in the current crisis. Following the amendments, it appears that many types of private-sector transactions that had been structured as loans secured by mortgages or related securities were instead configured as repo transactions, enabling deals with the same economic function to adopt a form that exempted them from bankruptcy control.

Swaps are agreements governed by ISDA (International Swap Dealer Association) forms in which the parties agree that party A will pay to party B a certain sum at a future date, with the sum to be paid calculated against some external standard, such as a currency fluctuation or an interest rate change. Swaps are often used as a form of financial insurance, with credit default swaps serving a role akin to guarantees wherein A, for a fee, guarantees to pay to B the debt that C owes to B if C does not pay, if C goes into bankruptcy, or if some similar event occurs. It is this sort of credit insurance (notational amount estimated currently at \$62 trillion) that has created the greatest concern for the financial system, because companies like Lehman—and many companies



who are not so obviously financial companies—have written huge amounts of this insurance.<sup>4</sup>

Securities and commodities contracts are defined by reference to their respective regulatory statutes. The terms are relatively transparent—they mean what they seem to mean.<sup>5</sup>

Netting agreements are simply a sophisticated form of setoff of mutual debts, a process ordinarily governed by section 553 of the Bankruptcy Code. A master netting agreement permits netting across a number of otherwise unrelated contracts within the exempted categories just described, a form of offset<sup>6</sup> usually prohibited or substantially constrained in various ways by the Bankruptcy Code.

What all these financial assets have in common is that they are exempted from the operation of the automatic stay, the avoiding powers (e.g., concerning preferences and fraudulent conveyances), and the rules governing executory contracts in bankruptcy. As a consequence, the debtor's counterparties are free to sell their collateral or terminate their contracts with the debtor notwithstanding insolvency or the filing of bankruptcy, contrary to the most fundamental principles of bankruptcy law. For that reason, it may be impossible to reorganize a debtor whose assets included a substantial portion of such financial assets. Even in liquidation, the disappearance of the value represented by these assets may ensure that unsecured creditors will get little or nothing.

It is important to emphasize that the exemptions were substantially expanded by the 2005 amendments to the Bankruptcy Code. The amendments not only included specific additions, but employed very broad language that could include a number of contracts that fall outside the usual and customary boundaries of the financial assets concerned. The simplest example of explicit expansion is the repurchase (repo) agreement. As noted above, this exemption was originally limited to government and government-backed securities, but was expanded to include mortgages and mortgage-related securities and interests in the securitization of the same.<sup>7</sup> But the expansion also employed sweeping language. For example, the amendments added to the swap

<sup>4</sup> Note that, unlike conventional insurance, this sort of business is entirely unregulated.

<sup>5</sup> Nonetheless, there has been some unfortunate blurring of these provisions as well and it should be corrected. See the PLI article attached.

<sup>6</sup> Setoff and offset mean essentially the same thing.

<sup>7</sup> Bankruptcy Code §101(47) (definition of repurchase agreement).

exemption provisions that defined swap agreements as including agreements that are *like* swap agreements. I have been told by a number of lawyers that the bar is busily revising ordinary commercial contracts into the form of swap agreements so the contracts may enjoy immunity from assumption or rejection under the Bankruptcy Code and the counterparties may use master netting agreements to offset the profitable contracts against the unprofitable ones, something that would not be permitted in a normal bankruptcy<sup>8</sup> because of the sharing principle.

It is very difficult to analyze the financial condition of Lehman Brothers at the time of its Chapter 11 filing because of a lack of financial data in readily available and manipulable form. It reported overall assets of \$639 billion and debts of \$613 billion.<sup>9</sup> It is said to have as much as \$160 billion in unsecured debts.<sup>10</sup> Much of its asset base no doubt consisted of financial assets exempt from the automatic stay and the bankruptcy avoiding powers. Thus it is highly likely that many of its assets, probably overvalued to start, walked out the door just before or shortly after its bankruptcy filing, leaving only the dregs, relatively speaking, for the other creditors and stakeholders.<sup>11</sup> It was reported that creditors expected an orderly liquidation, but it has also been reported that some counterparties have not exercised their rights because of various uncertainties. Anecdotally, in a number of recent defaults parties have been hesitant to liquidate repos and other exempted positions because of the very low asset values available in the market. On the other hand, the Wall Street Journal reported that a “private” trading session was held for traders to settle or unwind their contracts with Lehman on the afternoon before it filed, in circumstances described as “chaos.”<sup>12</sup> The bankruptcy law is designed to solve such difficulties, by taking a global and orderly approach to liquidation or reorganization, but the law cannot help where it has no power. The 2005 amendments greatly reduced the power of the bankruptcy laws for a large sector of the economy.

<sup>8</sup> For extended discussion of the changes, see the PLI article attached.

<sup>9</sup> Lehman Brothers Bankruptcy Petition at p. 17.

<sup>10</sup> Its 30 largest unsecured creditors were owed in excess of \$155 billion, including at least \$150 billion in bond debt. *Id.* at Schedule 1.

<sup>11</sup> It appears the estate will get less than \$5 billion for all of Lehman’s broker-dealer business, one of the largest in the world. It’s not clear what else has been left behind as the favored creditors exited.

<sup>12</sup> Crisis on Wall Street as Lehman Totters, Merrill Is Sold, AIG Seeks to Raise Cash --- Fed Will Expand Its Lending Arsenal in a Bid to Calm Markets; Moves Cap a Momentous Weekend for American Finance, Wall S. J. September 15, 2008, p. A1.

For these reasons, Congress should consider rolling back the 2005 amendments. We have no hard data on their effects, because the current crisis is the first since their adoption. For that reason, I am unable to point to specific examples of the adverse effects of the financial-asset exemptions. But I do not think Congress should await data while a natural experiment is conducted on the futures of American businesses and their creditors. The markets affected by these exemptions were vigorous and growing before these amendments were adopted. Their repeal is unlikely in my judgment to slow those markets except insofar as it might deter too-risky transactions, a positive development. Ideally, that repeal would be combined with appropriate steps to regulate those aspects of the markets that have helped to produce the current turmoil.

I do not suggest that Congress should immediately repeal all of these exemptions. There may be good reason for some of them under some circumstances, especially with respect to major financial institutions subject to regulation. However, the 2005 amendments have been in effect less than three years. It is unlikely that any seriously adverse consequences would arise from repealing those over-broad and ambiguous changes and then studying carefully the pluses and minuses of the remaining provisions. Business can and will adjust to a return to the prior rules. While prior transactions may have been structured to take advantage of legal loopholes, it is almost always the case that these same deals can be done through other structures to conform to the legal changes Congress finds to be necessary and fair.

If it is claimed that certain transactions could not be done without these exemptions, the first response, as my Wall Street friend noted, is that a transaction too risky to face equitable treatment in bankruptcy is too risky period, especially for a bank or quasi-bank. If the claim is made that the result will be increased costs, I think that close examination will often show that the savings permitted by these structures are simply the result of the illegitimate advantages they give over the other creditors and stakeholders in a bankruptcy case. In other words, if I favor Jones over Smith in bankruptcy, Jones will undoubtedly have lower costs but it is nearly certain those costs will be offset or more than offset by Smith's increased costs. Given that centuries of experience have shown that the orderly resolution of financial distress is preferable to post-default chaos and purely private maneuvering, the burden of showing a net increase

in efficiency would seem to be on those seeking to obtain or retain exemptions from that process.

Some will argue that bankruptcy has nothing to contribute to the resolution of the financial distress of a business with financial assets of the sort discussed in these remarks. They may say that financial institutions must have their own liquidation or reorganization process, as do banks and insurance companies. But it is evident that those specialized bankruptcy procedures always involve government money and therefore require government regulation of the covered firms. It is unlikely that most policymakers would want to extend both compulsory insurance and regulatory oversight to every hedge fund and other hybrid business that has some significant percentage of financial assets. Thus it is crucial that those businesses have some effective forum for orderly, predictable, and fair resolution of financial distress. Chapter 11, which is admired and often copied all over the world, has for many years been the favored method in American law. Yet Chapter 11 cannot work successfully if the bankruptcy process has no control over substantial financial assets of the distressed debtor. Congress should exempt regulated financial institutions from ordinary bankruptcy proceedings, rather than exempting financial assets.

With regard to the current crisis, it seems likely to me that counterparties faced with inadequate and chaotic results without government intervention would likely be open to waiving their exemption rights where waiver was made a condition of government funding of their debtor. A waiver condition may therefore be a useful tool in the government's crash-prevention toolbox. As in the 1930's, a systemic crisis requires and permits steps that would not be desirable in ordinary times. I wrote an article concerning the special circumstances of systemic crisis some years ago for a World Bank symposium, copy in the appendix. I have argued that we should consider adopting special legal rules to be applied when a systemic crisis arises. I also recommend Robert Shiller's recent column discussing that point in the New York Times.<sup>13</sup>

After the debacle of the Great Depression, lawmakers erected a number of levies to contain troubled financial waters. Perhaps understandably, later generations who

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<sup>13</sup> Robert Shiller, *Crisis Averted. What of the Next One?* New York Times August 10, 2008. Professor Shiller discusses the need for an overall strategy for resolving systemic crisis. He cites my article concerning the need for special bankruptcy rules when a systemic crisis arises.

viewed history through the lenses of happier times found the restrictions confining as well as inconsistent with the new creed of market autonomy. They deconstructed the history and tore down many of the levies and flood gates that seemed merely quaint in light of broader and calmer waters. Many of them now regret it. Repeal of the 2005 amendments concerning the exemption of financial assets represents a simple and relatively clean preparation for whatever new structures Congress adopts going forward.

#### Citations for Appendix

Jay L. Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795 (2004).

Edward R. Morrison and Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641 (2005).

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Ms. SÁNCHEZ. Professor Adler.

**TESTIMONY OF BARRY E. ADLER, ESQ., PROFESSOR,  
NEW YORK UNIVERSITY SCHOOL OF LAW, NEW YORK, NY**

Mr. ADLER. Thank you, Chairwoman Sánchez. I will resist the academic instinct to try to debate Professor Westbrook and I will stick to my statement for now which is——

Ms. SÁNCHEZ. You will probably have that opportunity during the questioning round.

Mr. ADLER. I am going to talk briefly this morning about large firm Chapter 11 bankruptcies and how they have changed over the past decade or so.

In the 1980's and early 1990's, the beginning of the new Bankruptcy Code, a large firm would get into financial trouble and file for bankruptcy. And the process looked something like this. The managers that were representing equity and in charge of the firm prior to bankruptcy also controlled the debtor in the bankruptcy. They were in charge of the reorganization plan and continued to manage the firm. These managers sometimes even kept their jobs after the firm reorganized, notwithstanding the fact that they had been in charge as the firm sunk to need bankruptcy.

In the bankruptcy process, there is a negotiation between the managers representing the equity holders and the creditors. The creditors often would go along with the manager's plan for reorganization and continuation of the firm, perhaps because they wanted to get out quickly or more quickly. These reorganizations sometimes dragged on. So quick wasn't always even possible. But the creditors would typically go down and not face a cram-down against their interests, but they bargained in the shadow of the possibility of that cram-down.

As a result, not surprisingly, frequently firms that emerged from bankruptcy would provide a return to equity holders even though the creditors are not paid in full. But the firms would survive very often, which has its benefits.

However, a theme of my comments this morning are that bankruptcy, which restructures the balance sheet of a firm, can't fix a broken firm. If the firm is economically distressed, if it is producing a product that no one wants and it costs a lot of money to make, that is going to be the case when it emerges from bankruptcy. And it was not uncommon for firms to fail a second time.

A recent study by Professor Lynn LoPucki showed that between 1991 and 1996, 30 percent of large firms that reorganized failed within 5 years. They didn't even survive 5 years.

So what has changed? Beginning in the late 1990's, early 2000, notably before the 2005 amendments, creditors became more aggressive and started to take control of the bankruptcy process. In fact, they started to take control of the firms in anticipation of the bankruptcy process. When a large firm enters bankruptcy today, they typically are already under the thumb. I may be more pejorative than I intend, but under the control of a secure creditor who has lent money to the debtor in an attempt to allow it to avoid bankruptcy. And when that fails, they are in control when they get into bankruptcy.

The secured lenders also provide the financing; that is, debtor in possession financing which is just jargon for a loan that is needed to keep the firm going in bankruptcy. The managers are routinely replaced. More often than not, that is, the old managers are gone. And if the firm reorganizes, there is nothing left for equity. Equity no longer gets payment. The creditors get paid in full.

A significant change which may be occurring in the data are somewhat complicated on this, but it is at least plausible that this change is occurring. These firms are liquidating more frequently than they used to.

The title of this hearing makes mention of Bennigan's and Sharper Image, which liquidated instantaneously, virtually upon the filing of bankruptcy. And there is evidence to suggest again, though somewhat mixed, that there is a trend toward the liquidation of bankruptcy, liquidation in bankruptcy of these firms.

It was mentioned in the Chairwoman's opening statements that there are new 2005 provisions that make this more common. The lease provisions, which give debtors a very short period of time to assume or reject leases, that may have contributed to this trend with respect to retailers in particular. But again the trend was organic, it was economic. It predates the 2005 amendments. So we do have these more frequent liquidations than we had in the past. And the question that we can talk about later is whether this is good or bad.

In sum, the point of my comments is it is potentially good. It is potentially better to have failed firms be liquidated. If they are dead economically, they are going to liquidate anyway. The assets can be redeployed to better uses. And if the liquidation is quick, creditors who get paid get a higher return than they otherwise would receive are more apt to lend to the next round of debtors. This will result in more employment and better plight for working families, which should be the focus of bankruptcy law anyway.

So it is not that I oppose or think that reorganization is itself a bad thing. It is a good thing if the firms were healthy. But when firms get into bankruptcy, it is typically because—or frequently because they are not healthy, they are not healthy economically. And if there is a trend toward more liquidation, this creditor control that is creating the greater liquidation may benefit society more than it is injuring it.

Ms. SÁNCHEZ. Thank you, Professor Adler. We appreciate your testimony.

[The prepared statement of Mr. Adler follows:]

## PREPARED STATEMENT OF BARRY E. ADLER

*Hearing on Lehman Brothers, Sharper Image, Bennigan's, and Beyond: Is Chapter 11 Bankruptcy Working?*

Over the past decade or so there has been a sea change in the process of bankruptcy reorganization for large, publicly traded firms. The traditional Chapter 11 paradigm, applicable in the 1980s and much of the 1990s, was that of a financially troubled debtor in bankruptcy to gain breathing room from creditors. The managers of the debtor before bankruptcy not infrequently remained in control of the debtor in bankruptcy, and sometimes after. During the Chapter 11 case, these managers, speaking for the debtor as an entity, orchestrated a plan through which the firm's debt would be reduced. Creditors, for their part, went along with the debtor often because the alternative was an extended negotiation after which the court might coerce (or "cram down") the debtor's plan anyway. Firms would routinely emerge from bankruptcy subject to a new capital structure regardless of whether there had been a cure for the economic woes that brought the firm into bankruptcy in the first place.<sup>1</sup> Matters are different today as debtor control of bankruptcy has given way to creditor dominance.

A large firm that enters bankruptcy today frequently has already pledged most or all of its assets to one or a number of secured creditors.<sup>2</sup> When the curtain opens on a typical case, a secured creditor has wrested or quickly wrests control of the case from the debtor's managers.<sup>3</sup> A frequent vehicle for such control is the debtor-in-possession (or "DIP") loan,<sup>4</sup> where a creditor, frequently an existing secured creditor, finances the continuing operation of the debtor in bankruptcy but with strings attached; these strings increasingly include vesting the lender with management prerogatives. In fact, all this might be arranged in advance of the bankruptcy filing, as part of a "prepackaged" or "prenegotiated" plan.<sup>5</sup> Not surprisingly, this environment yields a hard landing for the debtors' shareholders and managers. While in the 1980s it was routine for a bankruptcy reorganization to provide shareholders a return even though creditors were not paid in full,<sup>6</sup> such a return—sometimes called a violation of "absolute priority"—is a rarity now.<sup>7</sup> And in recent cases, top managers lose their jobs almost three-fourths of the time,<sup>8</sup> up from just above half of the time in the

<sup>1</sup> Frequently, there was no such cure. LoPucki & Doherty (2002) reports that almost a third of the large, publicly traded firms that reorganized in the United States from 1991 to 1996 went out of business within just five years. Moreover, more than 40% of these firms that reorganized in the Delaware bankruptcy court and 20% of those that reorganized in New York's Southern District filed for bankruptcy a second time within five years. This recidivism rate was much lower elsewhere in the country, but Delaware and New York were prominent bankruptcy venues.

<sup>2</sup> See Ayotte & Morrison (2007).

<sup>3</sup> See Baird & Rasmussen (2002, 2003); Skel (2003).

<sup>4</sup> See Dahiya, et al. (2003).

<sup>5</sup> See Baird & Rasmussen (2002, 2003).

<sup>6</sup> See Weiss (1990); Franks & Torous (1989).

<sup>7</sup> See Capkun & Weiss (2007); Ayotte & Morrison (2007).

<sup>8</sup> See Ayotte & Morrison (2007).



1980s.<sup>9</sup> Also, although the data are somewhat volatile across time and otherwise difficult to interpret, there is a general consensus that bankruptcy liquidations (including through a going-concern sale) of public companies are more common in this new era of Chapter 11 than in the past. For example, Lynn LoPucki, commenting on a database that he maintains, observes that “41 firms that filed bankruptcy as public companies each with assets exceeding approximately \$218 million liquidated in 2002, although no more than 8 such firms did so in any year prior to 1999.”<sup>10</sup> Liquidations, when they occur, also mean that a bankruptcy case can be conducted more quickly, with the bankruptcy process converted from a structured negotiation among investors to a forum for the mere distribution of sale proceeds.<sup>11</sup>

Note that the trend of creditor dominance in bankruptcy began before the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”). There are provisions of BAPCPA, however, that foster the new regime. For example, the Act amends Bankruptcy Code §1121 so that the debtor’s exclusivity period to file a reorganization plan cannot exceed 18 months; consequently, even those debtors who escape creditor control at the outset of the reorganization process can no longer control the bankruptcy process indefinitely, regardless of the court’s predilections, because once exclusivity ends a creditor can offer a competing plan for approval by the creditors as a group. The new law also amends §§1104 and 1112 to expand or strengthen the grounds for dismissal or conversion of, or appointment of a trustee in, a Chapter 11 case; these grounds are focused on ending debtor control of a case that is not making satisfactory progress towards an economically sound and financially feasible plan of reorganization.

Another provision that can have significant consequences, particularly for retailers, appears in §365(d), which generally gives a debtor who is a lessee only 120 days from the order for relief (in a voluntary case, the date of the bankruptcy petition) to accept or reject an unexpired lease of nonresidential real property. The court can extend this period, for cause, for another 90 days, but any extension beyond this requires the consent of the lessor. Debtor counsel has raised concern that particularly for a large business, such as a department store chain that rents its retail space, 120 days, or even 210 days, may be too short a time to determine which outlets should close and which should remain open. This adds pressure on a debtor to have worked out a bankruptcy resolution prior to filing a petition, consistent with the trend described above.

These BAPCPA provisions among others (including some directed specifically at expediting small business cases) reflect the belief that if a debtor cannot be reorganized quickly, there may be no viable business to save, in which case the best resolution is a swift turnover of assets to the debtor’s creditors, who can maximize their return with an efficient disposition such as an auction of the firm’s assets. And as noted, this statutory approach dovetails with the change in bankruptcy practice that began prior to the recent code revisions.

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<sup>9</sup> See Gilson (1990).

<sup>10</sup> See LoPucki (2003) at 646, fn. 5.

<sup>11</sup> See Ayotte & Morrison (2007).

All this raises the critical question of whether the new era of Chapter 11 is for the better. That is, did the judges who established the precedent of permissible creditor control and the Congress in 2005 get it right? Although no system is perfect, there is reason to believe that the answer to this question is “yes.”

This is not to deny that the failure of a business imposes costs on all involved, including suppliers, employees, and local communities. It is a mistake to assume, however, that these hardships can be avoided by a return to bankruptcy practice that more aggressively promotes reorganization. A new financial structure will not long help a debtor that is economically inviable. Firms do not enter bankruptcy randomly and while some good businesses find themselves in Chapter 11 because of a mere improper capital structure—one with too much debt—many, perhaps most, fail for old-fashioned reasons: a poor business plan badly executed. Put simply, bankruptcy law cannot help a debtor who entered bankruptcy because it offers an expensive product that customers do not want. Such a business will fail in or out of bankruptcy, reorganized or not, and if a futile reorganization attempt delays the day of reckoning and consumes resources that creditors could otherwise capture and reinvest society is not well served.

Let me illustrate this last point with an example provided to me by Todd Zywicki, a colleague in academia. Todd tells a story about a strip mall near his house. There was a Montgomery Ward in the strip mall as the anchor tenant for a Petsmart and other stores. In 1997, Montgomery Ward entered bankruptcy having been battered by competition from K-Mart, Target, and Wal-Mart. But Ward did not go gentle into that good night. Instead it endured a prolonged bankruptcy reorganization, closed many, but initially not all of its outlets, and emerged two years later, in 1999. During that time, the store near Todd’s home became rundown, perhaps because the debtor was unsure whether or not this location was one that would be restored or allowed to close. In addition, because this Ward location was such a weak store, as an anchor tenant it failed to draw foot traffic to the mall and the neighboring Petsmart was forced to close its doors. Finally, following Christmas 2000, the company finally gave up and closed all of its outlets, laying off all of its employees. The Montgomery Ward store near Todd was replaced by a Target outlet, which not only thrived but drew in customers for the mall’s other stores, which also thrived. Had Montgomery Ward closed down in 1997 rather than 2000, the store’s employees would have been deprived work at Ward for three years; this is true. But perhaps more jobs would have been created or saved at the Targets that replaced them and the Petsmarts that might have survived.

To be sure, not every liquidation is a good one, and one cannot know with certainty that the swift liquidations of Bennigan’s and Sharper Image, for example, were efficient. But a precept of finance is that higher returns to creditors at the time of collection implies lower interest rates for debtors at the time to borrow. That is, in a competitive credit market, the higher the expected return, the lower a creditor’s cost, the lower the price for money. So it may well be best that creditors quickly dispatch failed firms so that they have a maximum incentive to finance new ones. Even if one focuses myopically on the plight of working families and their communities, this may well be optimal, as healthy businesses provide greater opportunities for income than the sick and dying.

Finally, as an aside, I want to say a (very) few words about the Lehman bankruptcy. The salient feature of the Lehman case is the nature of the firm's assets, which include at the holding company or subsidiary level a number of financial contracts—forward contracts, swaps, and the like—that are provided special treatment under the Bankruptcy Code. Specifically, these contracts fit under safe harbors that permit counterparties of a debtor in bankruptcy to net their positions without fear of interference by the debtor's bankruptcy process. These provisions are designed to protect the functioning of the *markets* in these contracts rather than to advance the interests of the debtor in bankruptcy. Consequently, a discussion of what makes the Lehman case interesting is inapposite to a general discussion of Chapter 11, which is the focus of my intended contribution here.

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Ms. SÁNCHEZ. And now, Mr. Gottlieb, I want to invite you to give your testimony.

**TESTIMONY OF LAWRENCE C. GOTTLIEB, ESQ.,  
COOLEY GODWARD KRONISH LLP, NEW YORK, NY**

Mr. GOTTLIEB. Thank you, Chairwoman. Chapter 11 reorganizations are dead, and that really is not much of an overstatement. In the 3 years since the 2005 amendments took effect, we have seen no more than two retailers emerge from Chapter 11 as reorganized entities. Chapter 11 for retailers has become nothing more than a vehicle through which secured lenders sell the assets of the company through a quick sale process which provides retailers no opportunity to restructure their debts and rehabilitate their businesses.

Numerous prominent retailers have disappeared so far this year alone after filing for Chapter 11. They include Sharper Image, Levitz, The Bombay Company, Domain Furniture, Friedman Jewelers, Wilson's Leather and Luggage. The liquidation of just these seven retailers alone has resulted in the loss of approximately 15,000 jobs. The weak economy clearly has contributed to the downward spiral of retail reorganizations. But it just as clearly is not the cause of it. The real culprit are the amendments. Prior to the amendments, there were many successful and important retail reorganizations, including Federated Department Stores, Macy's, State Stores, P.A. Bergner and Zales, cases that often took years to be resolved. In my view, it is likely that most of these and other retail reorganizations would have failed if the amendments were in place at the time of their proceedings.

Although there are several amendments which, working together, have conspired to choke off retail reorganizations, there is one provision of the amendments that in our experience is so problematic for retailers that if every other onerous provision were remedied, save for this one, reorganization would still remain a pipe dream for distressed retailers.

We are talking about section 365(d)(4) of the Amendments of the Bankruptcy Code, which has been amended and provides for the time for which the debtor can assume or reject leases. In the old days before the amendments, they had 60 days to assume or reject the leases, which times could be extended and often were extended by the bankruptcy judges. The judges understood that it was important that the debtor have a sufficient time to try to reorganize. The problem with assuming or rejecting leases early is that if you assume a lease and then later reject it because the case fails or because your business plan determines that you should no longer have that lease, the landlords now have the enormous administrative claim which takes priority over taxes, employees, general unsecured creditors. The time before the Code when those amendments were in effect, the secured creditors were actually happy to fund the debtors because, after all, they could receive their interest, they were protected by the collateral. If and when it turned out that their collateral was in danger, they often would conduct going-out-of-business sales, which is really the place they need to liquidate that collateral. They have inventory. If they are going to liquidate it, they need to liquidate it in the stores, not on the street corners.

As long as the debtors maintain those stores, the financial institutions are more than willing to continue financing the debtors.

However, the amendments put an end to this dynamic by revising the section to provide a strict limit of 210 days, by which time a debtor must assume or reject its store leases. Extensions beyond the 210 days, irrespective of whether the retailer operates 10 stores or 1,000 stores, are not within the discretion of the bankruptcy courts. So even if a 1-day extension meant a difference between a reorganization or a liquidation that would cause 100,000 job losses, the bankruptcy judge, as a result of the amendments, is powerless to grant that extension. This new section has killed the Chapter 11 financing market.

The banks are saying essentially I need to be able to liquidate my inventory. It takes 90 days to liquidate that inventory. It takes 2 months to get the courts to approve that. That is 180 days or something like that. Because of that, the banks are going into the bankruptcies at the outset and are telling debtors at—retail debtors at the outset, we have no time; you either sell your assets within 2 months, and if you don't sell your assets within 2 months, you need to start your liquidation process. We are not helping you reorganize. We don't have time to let you reorganize. And my experience has been that every single case that I have been involved in, retail cases—and it has been dozens since the amendments went into effect—the banks have said the same things: You liquidate within 210 days, you start that liquidation 60 days into the case, one way or the other.

Now, because of that, the financing from the banks has totally dried up. In addition to that, there are a couple of other sections which we won't discuss at great length yet, which drain liquidity from debtors when they file Chapter 11—when retail debtors file Chapter 11. When the debtors file the Chapter 11 is when they need liquidity. They have no liquidity and that is why they are filing Chapter 11.

And there are other provisions which drain that liquidity at the very time they need it. They have to pay deposits to utilities, they have enormous section 503(b)(9) claims to vendors who have shipped within 20 days of bankruptcy, all of which the amendments combined with the 365(d)(4) on the leases have served to drain liquidity, prevent absolutely, no question in my mind, have absolutely prevented retailers from reorganizing. It is not irreversible. This is not a problem that can't be resolved, but some action needs to be taken right away.

Ms. SÁNCHEZ. Thank you, Mr. Gottlieb. We appreciate your testimony as well.

[The prepared statement of Mr. Gottlieb follows:]

PREPARED STATEMENT OF LAWRENCE C. GOTTLIEB

**The Disappearance of Retail Reorganization In the Post-BAPCPA Era**LAWRENCE C. GOTTLIEB<sup>1</sup>


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*To the extent we understand the law of corporate reorganizations as providing a collective forum in which creditors and their common debtor fashion a future for a firm that would otherwise be torn apart by financial distress, we may safely conclude that its era has come to an end.*<sup>2</sup>

The year was 2002, nearly three years before President George W. Bush signed into law the Bankruptcy Abuse Prevention and Consumer Act of 2005, S. 256 (“BAPCPA”), when Professors Baird and Rasmussen published this epitaph mourning the passage of chapter 11 as a means by which companies could restructure debt and emerge from bankruptcy as reorganized and rehabilitated entities. According to Baird and Rasmussen, structural changes in the U.S. economy over the preceding twenty-five years, including the national shift from a manufacturing economy to a service economy, the globalization of financial markets, and the increasing significance of intangible assets and intellectual capital, combined to leave the Chapter 11 process ill-suited for the twenty-first century.<sup>3</sup>

The factors cited by Baird and Rasmussen are certainly important to any macroscopic analysis of Chapter 11 reorganization, particularly in view of the significant “intangible asset” bankruptcies of Enron, WorldCom and Adelphia that dominated headlines years ago. But the systemic decline of Chapter 11 reorganization has also invaded the retail sector, where “hard assets” are no less prevalent today than they were in the 1990s, a time when many distressed

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<sup>1</sup> Lawrence C. Gottlieb is the Chair of the Bankruptcy & Restructuring Group of Cooley Godward Kronish LLP. The Cooley Godward Kronish Bankruptcy & Restructuring group has played significant roles in some of the largest bankruptcy and out of court restructuring cases. Cooley has represented creditors’ committees in such cases as Montgomery Ward, Federated Department Stores, Athlete’s Foot, Footstar, Inc., The Bombay Company, Florsheim Shoes, CompUSA, Levitz Home Furnishings, Inc., and Long John Silver’s Restaurants, Inc. Cooley currently represents creditors’ committees in such prominent retail chapter 11 cases as Sharper Image, Goody’s Family Clothing, Mervyn’s, Steve & Barry’s, Boscov’s, Domain, Shoe Pavilion, Lillian Vernon and Harvey Electronics. Cooley also represented the creditors’ committee of Hancock Fabrics, one of only two retailers since the implementation of the 2005 bankruptcy amendments to emerge successfully as an unimpaired reorganized entity, negotiating a plan providing for a 104.93% cash distribution to unsecured creditors. Mr. Gottlieb has authored numerous published articles on various retail bankruptcy issues, including the effects of the 2005 amendments on retail reorganization. Two of Mr. Gottlieb’s most recent articles, *The Death of Retail Reorganization?* appearing in the March 5, 2007 edition of the New York Law Journal and *The Benefits of BAPCPA? A Mirage for Retail Creditors* appearing in Volume 13, Number 3 of The Credit and Financial Management Review, are annexed hereto. Also annexed hereto is Mr. Gottlieb’s presentation *Problems in Retail Cases in BAPCPA* from the 25<sup>th</sup> Annual Advanced Business Bankruptcy Course held in Dallas, Texas in February 2007.

<sup>2</sup> Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN L. REV. 751, 753 (2002).

<sup>3</sup> See generally *id.*

retailers used the significant powers and protections of the Chapter 11 process to resuscitate their businesses.<sup>4</sup>

Today, retailers almost invariably begin the Chapter 11 process with little hope of emergence. Numerous economic factors – the credit crunch, the subprime lending crisis, the slowdown of the housing market and eroding value of retail commercial leases – have clearly contributed to this downward spiral. But to pin the disappearance of retail reorganization solely on one or more of these economic factors would be to ignore the devastation wrought by BAPCPA in the healthier economic climates of 2006 and 2007.<sup>5</sup> Indeed, since the enactment of BAPCPA in late 2005, no more than two retailers have successfully emerged from Chapter 11 as reorganized entities.

It is our experience that BAPCPA, with its numerous provisions impacting corporate insolvencies, has made it nearly impossible for retailers to emerge from Chapter 11 under any economic conditions. BAPCPA's amendment to, and introduction of, some of the more crucial Bankruptcy Code sections affecting the retailer's ability to meet its liquidity needs and obtain necessary postpetition financing – the lynchpin to any successful retail reorganization effort – has had a devastating effect on the retailer's ability to reorganize. Now almost three years removed from the enactment of BAPCPA and having observed its impact on numerous retail Chapter 11 cases, we can objectively say that BAPCPA has so negatively impacted the retailer's ability to meet its liquidity needs in Chapter 11 that the decline of retail reorganization should be expected to continue even in healthier economic times.

Liquidity is the lifeblood of reorganization. Absent the ability to pay certain postpetition debts as they come due, including sums owed employees, vendors, common carriers, utility providers and estate professionals to name just a few, the prospect of a retail reorganization is little more than a pipe dream. Moreover, the question of whether these obligations can be met is rarely left to the discretion of the debtor. Most retailers contemplating a Chapter 11 filing have experienced sustained periods of liquidity problems and have relied on the secured lending of banks and other financiers for years preceding their bankruptcy filings.<sup>6</sup> Consequently, at the

<sup>4</sup> The Federated Department Stores case (*In re Federated Dep't Stores, Inc.*, Case No. 90-10130 (BP) (Bankr. S.D. Ohio 1990)) symbolizes the highly successful retail restructurings of that decade. Before its Chapter 11 case, Federated was saddled with \$7.5 billion of debt after its purchase as part of a highly leveraged takeover by Canada's Campeau Corporation in 1988. Faced with a declining business and loss of confidence among its vendors, Federated filed for Chapter 11 protection in 1990, where it was forced to quickly sell various key assets, including a portion of its real estate interests. Despite these problems, Federated was able to restructure its debt and triumphantly emerge from bankruptcy as a reorganized entity in 1992 by swapping \$5 billion in debt and other liabilities for new notes and equity. Federated went on to acquire Macy's in connection with Macy's Chapter 11 case in 1994 and by 1998 Federated's debt was rated as "investment" grade by the major rating agencies.

<sup>5</sup> Although BAPCPA was signed into law on April 20, 2005, most of its provisions did not become effective until October 17, 2005. It is telling that a number of large companies that have either reorganized or are in the process of reorganizing, including Delta, Northwest and Delphi, filed their Chapter 11 cases in the month prior to BAPCPA's effective date.

<sup>6</sup> The growth of the second lien lending market over the past five years has compounded these liquidity problems for distressed retailers. Not only must retailers position themselves to pay the present value of the often substantial secured claims of their senior lenders upon confirmation of a Chapter 11 plan, but many now face a relatively new and additional layer of secured debt that must also be paid in full upon emergence. Second lien



commencement of most cases, substantially all of a retailer's assets will be subject to the prepetition liens of its lenders and may not be used or sold without their consent.

Lenders are disinclined to permit the use and disposition of their collateral and, just as important, to extend additional financing, absent a firm belief in a debtor's capacity to effectively reorganize and thereby avoid any diminution in the value of their collateral. Lenders have little to gain from the reorganization process unless it yields sufficient funds to repay the present value of their indebtedness, which, in most instances, includes significant amounts of outstanding prepetition loans. Where a prepetition lender does not possess the requisite level of confidence in a given debtor prior to or during the Chapter 11 process, it will inevitably attempt to force a sale of the collateralized assets pursuant to section 363(b)<sup>7</sup> of the Bankruptcy Code.

As discussed herein, BAPCPA's amendments to the Bankruptcy Code have stifled prospective retail reorganizations at the ground floor and beyond. New restraints on a debtor's liquidity reserves have quelled the appetites of already cautious lenders to provide the requisite levels of postpetition financing to even attempt reorganization. Furthermore, new provisions expanding the universe of claims entitled to administrative priority treatment have created an atmosphere of doubt as to whether a retailer could possibly possess enough cash at the end of a reorganization to pay such claims in full at confirmation. But perhaps the most troubling aspect of BAPCPA is its revision to section 365(d)(4)<sup>8</sup> of the Bankruptcy Code.

Prior to BAPCPA, section 365(d)(4) of the Bankruptcy Code was a powerful tool used by retailers to downsize operations while simultaneously adding considerable value to the estate. Under the old regime, a debtor had 60 days to decide whether to assume or reject its commercial real estate leases, without the consent, and often over the objection, of its lessors. This 60-day period was subject to extension "for cause." Such extensions were routinely granted by courts presiding over mid-size and larger cases, where the requesting debtor was continuing to perform its lease obligations. Furthermore, the Bankruptcy Code placed no limit on the duration or number of extensions that could be sought.

Perhaps the past practice of providing unlimited extensions of the assumption/rejection period was unnecessary. It is clear that this practice created a substantial backlash among landlords and others that ultimately produced the truncated assumption/rejection period provided under BAPCPA. But the pendulum has swung too far. As discussed below, the fixing of an

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lending originated in the early 1990s when the debt market stalled as a result of increased conservatism among banks and other traditional senior lenders. Second lien holders, in contrast to mezzanine loan holders, invariably play an active role in the Chapter 11 process because, in the event of a borrower default, the second lien holder can exercise its remedies (including foreclosure) against the debtor. While the second lien market has benefited distressed retailers by providing new channels of liquidity, it has also created more difficulties for those companies attempting rehabilitation in the face of both senior and second lien debt. Second lien loans have increasingly become a favorite investment vehicle of private equity firms that are judged by their internal rate of return on investments. These firms profit from generating quick returns on investment and, accordingly, are even less willing to endure the reorganization process than banks and other financial institutions.

<sup>7</sup> 11 U.S.C. § 363(b).

<sup>8</sup> 11 U.S.C. § 365(d)(4).

immutable deadline for the assumption or rejection of commercial real estate leases has dealt a knockout blow to prospective retail reorganizations.

From a lender's perspective, a retailer's ability to routinely obtain extensions of the assumption/rejection period provided two critical protections. First, a lender could be assured that the retailer was provided with sufficient time to analyze the value of each individual store lease before making the critical decision to assume or reject the lease. Second, lenders were also assured that they would be provided with enough time to conduct a "going-out-of-business" ("GOB") sale on the premises in the event a decision was subsequently made to terminate the reorganization process. Although both protections play important roles in a lender's decision to provide postpetition financing, it is the latter protection which is most crucial. Absent the ability to conduct a GOB sale from the debtor's store locations, a lender is deprived of the most commercially viable location to liquidate the collateralized inventory.

BAPCPA revises section 365(d)(4) to place an outside limit of 210 days on the time by which a debtor must assume or reject a commercial real estate lease. Specifically, section 365(d)(4) now provides that a commercial real estate lease is deemed rejected if not assumed by the debtor by the earlier of (i) 120 days after the petition date; or (ii) confirmation of a plan. Courts are authorized to extend the 120-day period for up to an additional 90 days for cause shown. Extensions beyond 210 days – irrespective of whether the retailer operates 10 stores or 1,000 stores – are not within the discretion of the bankruptcy courts and may only be granted upon the consent of the landlord. The effects of revised section 365(d)(4)'s limitations on the time and manner by which commercial leases must be assumed or rejected has dramatically reduced the debtor's ability to obtain postpetition financing sufficient to fund a reorganization. The 210-day limit leaves little room between the commencement of a case and the time by which a GOB sale must be implemented so as to conclude within the 210-day limit. Consequently, most prepetition lenders now refuse to provide any more postpetition financing than necessary to fund an immediate sale or liquidation process.

Moreover, a lender's traditional willingness to advance postpetition financing was rooted in part on the value of a debtor's commercial leases that could be monetized in the event of a failed reorganization effort. Prior to BAPCPA, lenders were far more willing to finance a debtor's reorganization, partly because the Bankruptcy Code essentially provided them with an indefinite period of time to assign the debtor's below-market commercial leases to third parties at a premium in the course of a subsequent liquidation. Revised section 365(d)(4) appreciably lessens the residual value of a debtor's commercial leases because lenders are left without sufficient time to market those leases in the event the reorganization stalls.

Retail cases filed over the past three years have invariably taken one of two forms: either the case is filed as a liquidation or the debtor is given a window of no more than three to four months to complete a reorganization process that history dictates takes at least three times that amount of time to accomplish. The most compelling explanation for this development is that both retailers and their lenders are acutely aware that even a full seven months in the life of a retail debtor is not a long time, as most retailers and their lenders cannot judge the vitality of the business without going through at least one Christmas season. Absent the ability to extend the assumption/rejection period beyond the 210-day limit, a debtor will often be forced into the impossible position of having to prematurely determine whether to assume or reject its

commercial leases – decisions of critical importance to the ultimate success of any reorganization. Accordingly, even in those cases where the lender has agreed to provide financing on a preliminary, “wait-and-see” basis, such willingness has invariably been tempered – if not extinguished – by the very nature of the retail industry. Lenders are simply not willing to bear the risks associated with financing a reorganization for fear that the retailer may lose its store leases before a GOB sale is completed.

Beyond the impact of commercial lease issues on the reorganization process, retail reorganizations have traditionally been guided by the interplay between a debtor’s liquidity needs and a lender’s confidence in positioning the debtor to meet those needs. BAPCPA places new and severe handicaps on a retailer’s liquidity at the very beginning of a case – the time at which liquidity is most crucial – through various amendments, including those concerning the treatment of trade creditors, utility providers, *ad valorem* tax claims and employee wage priorities.

Revised section 366<sup>9</sup> of the Bankruptcy Code represents another new and significant liquidity hurdle that a retailer must clear on its path to emergence. Revised section 366 provides that a debtor must, within 20 days of the filing, provide its utility providers (e.g., electric, gas, water, telephone) with adequate “assurance of future payment” in the form of a cash deposit or other security in order to prevent the discontinuation of service. Courts have interpreted this provision as requiring a debtor to provide each utility provider with a cash deposit in an amount generally ranging from two weeks to two months of service, calculated based on the debtor’s historical average use. Moreover, payment of a cash deposit does not relieve a debtor of its obligation to remain current with respect to services provided by utility providers subsequent to the filing. Accordingly, a debtor with a significant number of stores is now required to disburse what could be millions of dollars to utility providers, and deal with the associated administrative burdens of making and tracking such deposits, within the first 20 days of its case and without any corresponding offset to its obligation to pay such providers on account of their postpetition services.

BAPCPA’s revision of section 366 abrogates the long-standing practice that adequate assurance of future payment does not require a guarantee of payment, as courts routinely held that administrative priority claims granted to utility providers were sufficient assurances of future payment. Revised section 366 expressly prohibits the granting of an administrative priority claim as adequate assurance of future payment. The effects of this revision on a debtor’s liquidity at the very beginning of a case are severe, particularly for retail debtors with numerous locations requiring multiple utility services.

BAPCPA also makes notable changes to the Bankruptcy Code provisions governing the subordination and priority of *ad valorem* tax liens on a debtor’s real and personal property. Prior to the passage of BAPCPA, the payment of *ad valorem* taxes was usually subordinated to prior-secured claims. However, pursuant to amended section 503(b)(1)(B)<sup>10</sup> of the Bankruptcy Code, *ad valorem* tax claims incurred postpetition may prime secured and administrative priority

<sup>9</sup> 11 U.S.C. § 366.

<sup>10</sup> 11 U.S.C. § 503(b)(1)(B).

claims, regardless of whether the claim is secured or unsecured or whether the liability for the property tax is *in rem* or *in personam*. The revisions to the Bankruptcy Code sections governing *ad valorem* tax liens further compress liquidity, as postpetition *ad valorem* tax claims are afforded a greater priority for distribution purposes. Accordingly, a lender would likely reserve against loan availability an amount up to one year of a debtor's estimated *ad valorem* taxes, at the expense of cash made available to finance a reorganization.

Revised sections 507(a)(4)<sup>11</sup> and (a)(5)<sup>12</sup> of the Bankruptcy Code further compress the debtor's initial liquidity by raising the aggregate monetary limits on employee wage and pension benefit priority claims. Formerly, the aggregate amount that an employee could assert as a priority wage or pension benefit claim was limited to \$4,925 in wages and pension benefits earned within 90 days prior to the filing. BAPCPA increases the aggregate cap to \$10,950 for wages and pension benefits earned within 180 days prior to the filing. While it may be difficult to protest this revision from a moral perspective, the ramifications of revised section 507(a) on a debtor's liquidity are obvious, as these claims are generally paid within the first days of a Chapter 11 case.<sup>13</sup>

The addition of section 503(b)(9)<sup>14</sup> of the Bankruptcy Code creates an administrative claim, not available prior to BAPCPA, for goods actually received by the debtor within the 20 days prior to the Chapter 11 filing. For large retailers receiving high volumes of inventory with a reasonable turnover (often a significant portion of a retailer's trade debt arises in the month prior to bankruptcy) this new provision creates a large class of administrative claims that gives rise to severe liquidity concerns. Because the so-called absolute priority rule prohibits the confirmation of a plan of reorganization where administrative priority claims are paid less than full value at confirmation, section 503(b)(9) creates an enormous obstacle to any retail reorganization effort.

Prior to BAPCPA, a debtor's failure to pay for goods received within the 20 days preceding the commencement of its case gave rise to an unsecured prepetition claim, subject to very limited reclamation rights. These prepetition claims would ordinarily be paid by a debtor on the same *pro rata* basis as other unsecured claims under a confirmed plan. Now, however, a debtor is required to have available funds sufficient to cover these new, and potentially massive, administrative priority claims.

Lenders are simply disinclined to finance a retailer's bid for reorganization in light of the fact that a debtor must now be positioned to pay in full at confirmation a massive class of claims traditionally entitled to no more than a discounted unsecured distribution. And, as noted above, to the extent that lenders continue to refrain from providing sufficient postpetition financing, the

<sup>11</sup> 11 U.S.C. § 507(a)(4).

<sup>12</sup> 11 U.S.C. § 507(a)(5).

<sup>13</sup> The disappearance of retail reorganization as a result of BAPCPA has resulted in devastating job losses in the retail sector. For example, the inability of The Bombay Company to reorganize earlier this year resulted in the loss of approximately 3,800 jobs. The liquidations of Sharper Image and Wickes Home Furniture resulted in the loss of approximately 2,200 and 1,500 jobs, respectively.

<sup>14</sup> 11 U.S.C. § 503(b)(9).

benefits of section 503(b)(9) will rarely be reaped by trade creditors simply because retailers will be deprived of the requisite funding needed to attain administrative solvency at confirmation.

BAPCPA has left retailers without adequate time and money to effectuate operational initiatives and cost cutting measures needed to resuscitate their businesses. Retailers now enter the Chapter 11 arena with little choice but to narrowly tailor their strategy to ensure that their lenders are not deprived of the substantial benefits and protections conferred by section 363(b) of the Bankruptcy Code, which authorizes the use, sale or lease of estate property outside the ordinary course of business upon court approval. Section 363(b) offers the unique ability to cleanse the assets of a distressed company by permitting debtors to convey assets “free and clear,” thereby maximizing value by removing the uncertainty of such stigmas as successor liability, fraudulent transfer claims and lien issues that often accompany asset purchases. Prepetition lenders, cognizant of this powerful liquidating tool and mindful of the numerous liquidity hurdles that the debtor must clear as a result of BAPCPA, have little to gain by risking their collateral in pursuit of a reorganization process now widely perceived as hopeless.

Indeed, the constricted time frames and liquidity problems created and imposed by BAPCPA have effectively eliminated the need for existing lenders to provide any more financing than necessary to position the debtor to liquidate its assets in the first few months of the case. Today, the debtor is no longer “in possession” of its assets or its future upon the commencement of its Chapter 11 case. BAPCPA’s constrictive liquidity provisions and the enormous leverage handed to secured lenders as a result thereof have eliminated the ability of retailers to control the Chapter 11 process as a “debtor-in-possession.” Rather, the process is now controlled almost exclusively by prepetition lenders, who have essentially assumed the role of “creditor-in-possession.”

The increasing influence of prepetition lenders has fundamentally changed the reorganization dynamic, with wide-ranging and far-reaching effects both prior to and during the Chapter 11 case. Because retailers that file for Chapter 11 protection today increasingly have balance sheets that are encumbered by ever growing amounts of secured debt, there is virtually no ability for these companies to survive on cash collateral alone. Retailers today invariably need to turn to postpetition financing (or “DIP financing”) immediately upon the commencement of the case. DIP financing agreements generally take the form of a revolving credit facility, with amounts borrowed due on a regular and relatively short-term basis, and typically include regular reporting requirements to allow the lenders to evaluate the debtor’s performance frequently and to determine whether the loan should be “rolled over” (i.e., to apply the proceeds of the lender’s postpetition loans against the lender’s prepetition indebtedness).

As a result of the liquidity and timing problems imposed by BAPCPA, negotiations over DIP financing agreements have become more and more one-sided, with lenders’ leverage substantially enhanced by their vast prepetition liens and security interests. Such leverage has enabled DIP lenders to impose increasingly severe conditions on retailers and their activities. Lenders now routinely negotiate critical provisions into DIP financing agreements that either direct the retail case towards an immediate liquidation or include covenants or borrowing reserve rights that effectively permit the lender to cease lending only a few months into the case. Although the latter scenario provides a temporary breathing spell for the retailer, the reality is

that three or four months into a Chapter 11 case is vastly insufficient for the retailer to even attempt to restructure its business and gain the support of its various creditor constituencies.

The three most recent large retail filings illustrate the various paths taken by lenders to reach the common destination of a section 363(b) asset sale. It is important to note that each of these cases is currently pending and, accordingly, their ultimate disposition has not yet been determined. However, these cases provide helpful illustrations of the different ways in which lenders have assumed the reigns of the retail Chapter 11 process from the outset.

#### A. Steve & Barry's

Steve & Barry's<sup>15</sup> filed a voluntary petition for chapter 11 protection in the Southern District of New York on July 9, 2008. On the petition date, together with their other first day motions, the Debtors filed a motion requesting authorization to use cash collateral. On July 11, 2008 (well before the creditors' committee was appointed and provided an opportunity to weigh in), the court entered an interim order granting the Debtors' cash collateral motion. The order provided that the Debtors' failure to perform any of the following "sale trigger events" by their respective dates would constitute an event of default:

- On or before July 24, 2008, unless the prepetition revolver agent and the Debtors agree otherwise, the Debtors, after consultation with the creditors' committee and the prepetition revolver agent, must have accepted a stalking horse bid from a stalking horse that is reasonably acceptable to the prepetition revolver agent.
- On or before July 29, 2008, the court must have approved and entered a sale procedures order with respect to a going concern sale or full chain liquidation, in form and substance satisfactory to the prepetition revolver agent.
- On or before August 12, 2008, the Debtors must complete the auction for a going concern sale or full chain liquidation.
- On or before August 14, 2008, the Debtors must receive the approval of the court for a going-concern sale or full chain liquidation, and the order approving such a going concern sale or full chain liquidation must be in form and substance satisfactory to the prepetition revolver agent.
- On or before August 15, 2008, the Debtors must have executed all of the agency documents, to the extent applicable, or purchase agreements and all other relevant documents in connection with a going-concern sale or full chain liquidation.

<sup>15</sup> *In re Steve & Barry's Manhattan LLC et al.*, Case No. 08-12579 (ALG) (Bankr. S.D.N.Y. July 9, 2008).

- On or before August 15, 2008, to the extent applicable, the going-concern sale shall have been consummated, or the full chain liquidation shall have commenced.

Pursuant to the interim order entered by the bankruptcy court, upon the occurrence of an event of default, the lenders were entitled to declare a termination, reduction or restriction of the ability of the Debtors to use any cash collateral, and any automatic stay otherwise applicable would be modified so that five business days after the lenders' notice of such termination, the lenders would be entitled to exercise their rights and remedies to satisfy any obligations under the interim order.

The Steve & Barry's case exemplifies the fast-track liquidation approach now taken by many retail lenders. As illustrated above, the sale transaction of Steve & Barry's as either a going concern entity or through an orderly liquidation under section 363(b) was required to be consummated *barely a month* into the case. The company was provided with no breathing spell, no chance to implement strategic initiatives that might attract new financing, and no opportunity whatsoever to emerge as a rehabilitated company under existing management.

#### **B. Mervyn's**

In other instances, lenders have been more willing to provide distressed retailers with an opportunity to reorganize, provided that such efforts do not interfere with the lender's ability to liquidate its collateral in a section 363(b) sale. For example, in the Mervyn's case<sup>16</sup>, filed in the District of Delaware on July 29, 2008, the retailer's senior lender agreed to provide DIP financing to the company through the continuation of a prepetition revolving credit facility under which the company's borrowing availability was calculated as a percentage of its inventory value. Importantly, however, the DIP financing agreement, as ultimately approved by the bankruptcy court, empowers the lender to create various "reserves" against the company's borrowing availability under the credit facility. Specifically, the senior lender was permitted to, at any time and in any increment, establish a reserve:

To reflect the value of inventory at leased locations with respect to which the lease therefore has not been assumed commencing on the date that is ten (10) weeks prior to the end of the one hundred twenty (120) day lease rejection/assumption period, as such period may be extended by the Bankruptcy Court or shortened by the Bankruptcy Court.

This reserve is the direct result of BAPCPA's condensed time frame within which a debtor must assume or reject its commercial real estate leases. The purpose of this reserve is to ensure that the lender will be well positioned to liquidate Mervyn's inventory through GOB sales before such leases are rejected in the context of a liquidation. The reserve effectively provides the lender with the unfettered right to stop lending to Mervyn's on the date that is 10 weeks prior to

<sup>16</sup> *In re Mervyn's Holdings, LLC, et al.*, Case No. 08-11586 (KG) (Bankr. D. Del. July 29, 2008).

the conclusion of the 210-day lease assumption/rejection period.<sup>17</sup> Thus, in order to stave off a lender-driven liquidation of its assets, Mervyn's, a company that recorded net sales of approximately \$2.5 billion during the fiscal year ending February 2, 2008, would have no more than four months to, among other things, develop and initiate operational initiatives and cost-cutting measures sufficient to attract exit financing and entice its vendors to continue manufacturing and shipping product on customary credit terms.

### C. Boscov's

The postpetition financing arrangement approved by the bankruptcy court in the Boscov's case provides an example of the liquidation-oriented covenants that now regularly appear in DIP financing agreements. Boscov's<sup>18</sup>, which filed its Chapter 11 in the District of Delaware on August 4, 2008, became obligated under the court-authorized DIP financing agreement to possess certain minimum levels of inventory, and to incur expenses no greater than 110% of the amounts specified in the accompanying budget, commencing on August 16, 2008. Further, beginning on September 6, 2008, Boscov's became obligated to achieve operating cash receipts of not less than 90% of the amounts specified in the budget. Failure to meet these covenants would constitute an event of default under the DIP financing agreement that would permit the lenders to terminate the credit facility.

Importantly, each of these covenants was tied to Boscov's actual experience during the weeks *preceding* its Chapter 11 filing. For example, Boscov's actual expenses would be measured against the expenses projected in the budget for the preceding four-week period. Because this multi-week "look back" would include the date of Boscov's Chapter 11 filing, the company was required under the DIP financing agreement to achieve specified results for periods shortly before and after the bankruptcy filing, many of which were utterly unworkable given the disruption to Boscov's business that had been caused by the bankruptcy filing. In fact, Boscov's was plainly in default of these covenants *before* the bankruptcy court even approved the DIP financing agreement because the company was clearly not positioned to even approach these targets until late September. The inclusion of these covenants in the court-authorized DIP financing agreement effectively positioned Boscov's as a borrower under an "at will" credit facility, with the lenders positioned to call the loan and effectuate a liquidation process at any moment they perceive a risk to the value of their collateral base.

<sup>17</sup> Mervyn's request for a 90-day extension of the lease assumption/rejection period was authorized by order of the bankruptcy court. As noted above, as a result of BAPCPA's revision of section 365 of the Bankruptcy Code, the bankruptcy court is expressly prohibited from authorizing any further extension of this period.

<sup>18</sup> *In re Boscov's, Inc., et al.*, Case No. 08-11637 (KG) (Bankr. D. Del. August 4, 2008).



## The Credit and Financial Management Review

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*The Benefits of BAPCPA?  
A Mirage for Retail Creditors  
By: Lawrence C. Gottlieb &  
Seth Van Aalten*

**Abstract**

*On April 20, 2005, President George W. Bush signed into law the Bankruptcy Abuse Prevention and Consumer Act of 2005, S. 256 (the "Act"). While much of the initial publicity surrounding the Act was focused on certain provisions affecting individuals seeking relief under Chapter 7 of the Bankruptcy Code (the "Code"), the Act contains a myriad of provisions which significantly impact retail insolvencies. Many of these provisions offer significant improvements to the treatment of a variety of unsecured creditors in retail Chapter 11 proceedings, including three of the more critical provisions addressed in this article: the reduction of time by which a debtor must decide to assume or reject non-residential real property leases; enhanced adequate assurance of future performance for utility providers; and the granting of administrative expense priority claims to trade creditors supplying goods to a debtor within the 20 days prior to the filing. While these revisions and amendments to the Code seemingly improve the treatment of certain creditor constituencies, a deeper look at these provisions and their subsequent effect on retail reorganizations reveals that these "improvements" are little more than a mirage in the now barren desert of retail reorganization. Indeed, one would be hard pressed to find a single retailer of significant size that has emerged from Chapter 11 as a reorganized entity since the Act took effect.*

**The Fallacy**

Importantly, the consequences of a retailer's inability to reorganize its business extend well beyond the distressed company, its shareholders and employees. Retail debtors commonly possess massive amounts of unsecured debt at the commencement of a case, much of which dates back to years before the filing, and which invariably depresses the retailer's liquidation value to the point where a prepetition or pre-packaged liquidation of its assets may yield little or even nothing for creditors after payment of secured claims. Absent a retail debtor's ability to reorganize its business, unsecured creditors stand to lose not only the prospect of an emergent and healthy business partner, but also the hope of a negotiated plan of reorganization that pays significant portions of their prepetition claims at confirmation or over time. As discussed herein, the disappearance of retail reorganization can be attributed to the Act's "improvements" to the treatment of certain unsecured creditors under the Code. And if a retailer is positioned such that reorganization is no longer a viable restructuring alternative, then these so-called "improvements" will have actually placed unsecured creditors in a far worse position than they

occupied prior to the Act. For not only will the statutory benefits of the Act never be fully realized by such creditors, but their presence alone comes at the cost of a process that is critical to both the payment of past debt and restoration of formerly profitable trade relations.

Any successful reorganization effort is premised on a debtor's ability to pay certain postpetition obligations as they come due, including debts owed to employees, vendors, common carriers, utility providers and estate professionals. The question of whether these obligations can be met is rarely left to the debtor to answer. Most retailers contemplating a reorganization have experienced prolonged periods of liquidity problems and have relied on the secured lending of banks for years preceding their filings. At the commencement of most retail cases, substantially all of a debtor's assets will be subject to the prepetition liens of its lenders and may not be used or sold without their consent. Lenders are disinclined to permit the use and disposition of their collateral - let alone to extend additional financing - absent a belief in the debtor's ability to effectively restructure its debt and reorganize its business. Where a lender does not possess the requisite level of confidence in a given debtor prior to or during the reorganization process, it will inevitably force a sale of the collateralized assets pursuant to section 363(b) of the Code and avoid the risk of any further diminution in the value of its collateral.

Less than two years removed from the effective date of most of the provisions of the Act affecting Chapter 11 insolvencies, it is clear that the Act's amendments to the Code have stifled prospective retail reorganizations. New restraints on a debtor's liquidity reserves, coupled with an expansion of the rights and protections offered to certain unsecured creditor constituencies, have effectively pushed potential lenders away from the negotiation table. This article focuses on the Act's amendment to, and introduction of, three of the more crucial Code sections that have stripped away the very foundation of the retail reorganization process and the traditional benefits enjoyed by unsecured creditors thereunder.

#### **Revised Section 365(d)(4): The Primary Obstacle to Postpetition Financing**

Prior to the Act, section 365 of the Code was a critical tool by which retailers could downsize operations while adding considerable value to the estate. A retailer previously enjoyed an initial period of 60 days to decide whether to assume or reject a non-residential real property lease and a bankruptcy court could extend that time "for cause" without any statutory limitation on the frequency or duration of such extensions. In practice, such extensions were routinely granted through plan confirmation in mid-size and large retail cases. Under the Act's revisions to section 365(d)(4), the initial period to assume or reject non-residential real property leases is extended to 120 days. However, the court may only extend that period (again, "for cause") for up to an additional 90 days. Any additional extension may be granted by the court "only upon prior written consent of the lessor."

Revised section 365(d)(4) clearly benefits lessors – many of which hold substantial prepetition claims which will be elevated to administrative expense claims only in the event the lease is assumed by a debtor – by accelerating the process by which a debtor must decide the fate of a commercial property lease. However, the creation of the rather arbitrary outside cap of 210 days for assumption/rejection imposes a real and significant burden on debtors, especially in retail cases where numerous commercial property leases must be analyzed and where the consequences of an improvident assumption or rejection of what are likely significant estate

assets may be catastrophic. As an initial matter, the burden of simply analyzing numerous commercial property leases to determine whether their retention or rejection is valuable is an appreciable obstacle. A retailer will have no choice but to expend significant time and resources at the outset of its Chapter 11 proceeding, a time when it actually has very little of both, to evaluate the value of its leases and make crucial decisions of whether to assume or reject the leases within the first days of the case. Debtors no longer have the luxury of reserving decisions on assumption/rejection until a section 363 sale or plan confirmation – the general time by which debtors can be certain of unloading assumed leases with an accompanying assignment or of its own need for the leases as a reorganized entity. As such, the debtor and its creditors are confronted with precipitate lease decisions without the benefit of calculated results, leaving such decisions as mostly guesswork.

From a practical perspective, section 365(d)(4)(B)(ii)'s allowance of further extension upon prior written consent of the lessor is, at best, of limited value to a retailer. It is difficult to imagine a scenario where a lessor would consent to such an extension except under circumstances that principally (if not exclusively) favor the lessor. Where a lease is priced below market, the lessor will almost always decline to agree to a further extension in the hope that the debtor will reject the lease, thereby enabling the lessor to relet the premises to another tenant at a higher rental charge. Conversely, where a lease is priced above market, the lessor does have incentive to consent to a further extension, but in such instances the debtor will likely be inclined to terminate the lease as quickly as circumstances permit. But where a lease is priced approximately at market and so long as potential alternative tenants exist, the lessor's incentive will be to decline such an extension in the hopes of placing another – more solvent – tenant in the property at comparable or better rates.

From the perspective of a lender, a retailer's previous ability to routinely obtain extensions of the assumption period provided two critical protections. First, a lender could be assured that the retailer had sufficient time to properly analyze the value of each individual store lease before deciding its fate. Second, a lender could also be assured that it would be provided with sufficient time to conduct a "going-out-of-business" ("GOB") sale on the premises, in the event the reorganization was terminated. The latter protection is pivotal to the reorganization process because without the ability to conduct a GOB sale from the debtor's store locations, a lender is deprived of the most commercially viable location to liquidate the collateralized inventory and avoid further diminution in the value of the collateral.

The effects of revised section 365(d)(4)'s limitations on the time and manner by which commercial property leases must be assumed or rejected has dramatically reduced a debtor's ability to obtain postpetition financing. The 210-day limit leaves little room between the commencement of a case and the time by which a GOB sale must be implemented so as to conclude within the 210-day limit. Consequently, many prepetition lenders have refused to even consider providing postpetition financing, for fear that any subsequent decision to liquidate the company will come too late to effectuate a successful GOB sale from the debtor's store locations. Moreover, a lender's traditional willingness to advance postpetition financing was based in part on the inherent value of a debtor's commercial leases. A lender could be assured of additional value in the event that a debtor's portfolio included a number of below-market leases, as those leases could be easily assigned to third parties at a premium in the course of a

subsequent liquidation. Revised section 365(d)(4) appreciably lessens the value of a debtor's commercial leases through its shortened assumption period. As lessors are unlikely to consent to extensions of the 210-day limit, particularly in the context of below-market leases, a lender is left without sufficient time to market a debtor's commercial leases in the event that the reorganization is terminated.

Even assuming that a potential lender was willing to roll the dice on a reorganization, a retailer would be given no more than a few months to quell any notion of a GOB sale for the reasons previously discussed. However, both retailers and their lenders are acutely aware that even a full seven months in the life of a retail debtor is not a long time, as most retailers and their lenders cannot judge the vitality of the business without going through at least one Christmas season. Absent the ability to extend the assumption period beyond the 210-day limit, a debtor will often be forced into the impossible position of having to prematurely determine whether to assume or reject its commercial property leases – decisions of critical importance to the ultimate success of any reorganization. If a debtor is forced to prematurely assume a commercial property lease, only to then reject it as part of an overall restructuring plan or otherwise, such rejection would give rise to a potentially burdensome administrative expense claim for damages arising from the debtor's postpetition breach in an amount equal to the obligations owing under the lease for the period of two years following the later of the rejection date or the date of actual turnover of the premises pursuant to section 503(b)(7) of the Code. Conversely, if the debtor was to precipitously reject a commercial lease or have the lease deemed rejected by operation of section 365(d)(4) of the Code, then the debtor may be adversely affecting its on-going operations (as well as the process of soliciting bids in the context of a sale of the business) and thereby foregoing significant value to the detriment of its estate and creditors. Accordingly, even if a lender was willing to provide financing on a preliminary, "wait-and-see" basis, such willingness would inevitably be tempered – if not extinguished – by the nature of the retail industry and the potentially devastating consequences of improvident lease decisions.

Thus, while revised section 365(d)(4) seemingly benefits lessors by accelerating the time by which a debtor must assume or reject commercial leases, the effects of the revision on a debtor's reorganization prospects dampen this benefit. As the likelihood of a debtor's reorganization dwindles, so does the likelihood that commercial leases will be assumed by the debtor. And, as discussed above, the priority of a lessor's claim for prepetition rental charges and associated obligations will be elevated to administrative expenses only in the event that the lease is assumed by the debtor. Moreover, other unsecured creditors, including trade creditors, are forced to suffer the consequences of this revision. As the 210-day limit has squashed lenders' traditional willingness to advance postpetition financing, the prospect of retail reorganization – and the prospect of receiving meaningful returns on prepetition trade claims – has all but vanished.

#### **New Section 366(c): A Severe Drain on Front-End Liquidity**

Pursuant to section 366(a) and (b) of the Code, utility providers (e.g., electric, gas, water, telephone) are prohibited from altering or discontinuing service to a debtor unless the debtor fails to provide "adequate assurance" of future payment within 20 days after the petition date. The addition of section 366(c) provides new statutory parameters for determining what constitutes adequate assurance in the context of a Chapter 11 case, imposes a significant burden on debtors by removing much of the court's discretion with respect to the determination of what constitutes

adequate assurance of future payment, removes the possibility of using administrative expense priority as such adequate assurance, and effectively compels the placement of a cash deposit (or equivalent) with all utilities.

The burden of new section 366(c) is particularly onerous in the context of retail debtors who, with numerous locations served by multiple utilities, are now required to make large outlays of cash at the beginning of a case and manage the associated administrative burdens of making and tracking such deposits. In addition to stripping liquidity from the debtor at the preliminary stage of its Chapter 11 case, section 366(c)(2) appears, on the surface, to give complete discretion to the utility to determine whether the assurances proposed by a debtor are "satisfactory to the utility."<sup>11</sup> Finally, section 366(c)(4) eliminates the effect of the automatic stay and permits a utility to effectuate a setoff of a prepetition deposit against prepetition amounts owed by the debtor without notice or court order, thereby eliminating any bargaining power the debtor may have had to negotiate an agreed offset and relief from stay in the context of a global resolution of postpetition adequate assurance. Accordingly, a retail debtor with a significant number of stores is now required to disburse what could be millions of dollars to utility providers, and deal with the associated administrative burdens of making and tracking such deposits, within the first 20 days of its case and without any corresponding offset to its obligation to pay such providers on account of their postpetition services.

The revision abrogates the long-standing practice that adequate assurance of future payment does not require a guarantee of payment, as courts routinely held that administrative priority claims granted to utility providers were sufficient assurances of future payment. Revised section 366(c)(1)(B) expressly prohibits the granting of an administrative priority claim as adequate assurance of future payment. The effects of this revision on a debtor's liquidity at the very beginning of a case are severe, particularly for retail debtors with numerous locations requiring multiple utility services. Consequently, revised section 366 has nothing short of a devastating impact on a debtor's preliminary liquidity. Retail reorganization prospects have dwindled in light of the genuine concerns of postpetition lenders over the fact that they must now make a greater percentage of their loans available to the debtor (or increase the total amount of the loan from what would have been expected to be necessary prior to the Act) at a point where the debtor's reorganization prospects are suspect.

#### **New Section 503(b)(9): A Severe Drain On Back-End Liquidity**

The addition of section 503(b)(9) creates an administrative claim, not available prior to the Act, for goods actually received by the debtor within the 20 days prior to the petition date provided that such goods are sold to the debtor in the ordinary course of business. For a retail debtor receiving a high volume of inventory with a reasonable turnover - often a significant portion of a retailer's trade debt arises in the month prior to bankruptcy - this new provision creates large administrative claims that give rise to severe liquidity concerns. Because the so-called absolute priority rule prohibits the confirmation of a plan where administrative priority claims are paid

<sup>11</sup> 11 U.S.C. § 366(c)(2). At least one court has interpolated a possible good faith requirement. See *In re Lucre, Inc.*, Case No. 05-21732 (Bankr. W.D. Mich. 2005) (section 366(c) "could be read to require a utility to bargain in good faith with the trustee or debtor in possession before electing to discontinue service thereunder"; also found that section 366(c) applies only to traditional utility service consumed by debtor).

less than their full value at confirmation, the consequences of section 503(b)(9) are crippling in the retail context.

Prior to the Act, a debtor's failure to pay for goods received within the 20 days preceding the commencement of its case gave rise to a prepetition claim, subject to very limited reclamation rights. These prepetition claims would ordinarily be paid by a debtor on the same *pro rata* basis as other unsecured claims under a confirmed plan. As a result of the addition of section 503(b)(9), however, a debtor is now required to have available funds sufficient to cover these new, and potentially massive, administrative priority claims.

Although trade creditors have no doubt rejoiced at the prospect of receiving an elevated priority for goods sold within the 20 days preceding commencement, the reality is that this amendment has yet to – and will likely rarely – inure to their benefit in mid-size to large retail cases. As a practical matter, nothing in section 503(b)(9) requires *immediate* payment of these 20-day claims and, importantly, courts have not required these administrative claims be paid prior to confirmation. In fact, two recent decisions from Third Circuit bankruptcy courts have addressed and denied motions of trade creditors seeking immediate payment of administrative claims pursuant to section 503(b)(9).

In *In re Bookbinders' Restaurant*<sup>2</sup>, the Bankruptcy Court for the Eastern District of Pennsylvania addressed a trade creditor's motion seeking immediate payment of a 20-day claim on the ground that such administrative claims must, as a matter of law, be treated in the same manner as trade creditors holding section 363(c)(1) claims.<sup>3</sup> The Court rejected the creditor's argument and denied the motion, reasoning that section 503(b)(9) claims must be compared to other section 503 claims and not section 363(c)(1) claims. The Court held that trade creditors are not entitled to immediate payment of their 20-day claims *as a matter of law*, but left open the issue of whether a court could exercise its discretion to compel immediate payment of a section 503(b)(9) claim if warranted by the applicable circumstances. The Court reasoned that in exercising such discretion, it would consider three factors: (1) the prejudice to the debtor; (2) the hardship to the claimant; and (3) the detriment to other creditors. Without a sufficient record to weigh the enumerated factors, the Court ordered an evidentiary hearing to determine whether to compel payment in advance of confirmation.

In the *Global Home Products*<sup>4</sup> case, the parties agreed that the issue of payment timing is within the court's discretion and the Bankruptcy Court for the District of Delaware was required to address whether the factual circumstances at issue warranted an exercise of its discretion to compel the debtors' immediate payment of the applicable 20-day claim. Relying on the same

<sup>2</sup> *In re Bookbinders' Restaurant*, 2006 WL 3858020, No. 06-12302 (Bankr. E.D. Pa. Dec. 28, 2006).

<sup>3</sup> 11 U.S.C. § 363(c)(1). Section 363(c)(1) permits a debtor to enter into postpetition transactions in the ordinary course of its business and authorizes immediate payment for goods purchased postpetition. Payments made under section 363(c)(1) are considered "operational" payments, which "by their nature, enjoy a de facto priority over administrative expenses, without any express provision for superpriority." *In re Telesphere Communications, Inc.*, 148 B.R. 525, 531 (Bankr. N.D. Ill. 1992). Accordingly, section 363(c)(1) requires immediate payment for goods received by a debtor in connection with a postpetition transaction.

<sup>4</sup> *In re Global Home Products, LLC*, No. 06-10340 (Bankr. D. Del. Dec. 21, 2006).

three factors identified in the *Bookbinders*' decision, the Court found that the debtors' "tenuous financial position" suggested that they would suffer significant prejudice if required to pay the 20-day claim in advance of confirmation. Importantly, the debtors' postpetition lender objected to the trade creditor's motion on the ground that the court-approved postpetition financing agreement prohibited the debtors from paying any expenses not included in the postpetition financing budget without the lender's consent. Accordingly, a court order authorizing payment of the creditor's 20-day claim would have constituted a breach of the postpetition financing agreement and would thereby have prejudiced the debtors' estates and creditors. The Court ultimately denied the trade creditor's motion, reasoning that the "substantial harm" that would befall the debtors' estates and creditor bodies outweighed the "little prejudice or hardship" to be suffered by the trade creditor in having payment on its 20-day claim deferred until confirmation.

The *Bookbinders*' and *Global Home Products* decisions indicate the reluctance of bankruptcy courts to require immediate payment of section 503(b)(9) claims absent extraordinary circumstances. Indeed, one would be hard pressed to imagine a single scenario where the "balance of the hardships" would favor immediate payment of a 20-day claim over the substantial harm to be suffered by a debtor's estate and creditors, as a whole, to the extent a debtor is required to make administrative claim payments not accounted for in a negotiated postpetition financing arrangement.

Moreover, new section 503(b)(9) threatens a retailer's ability to obtain postpetition financing in the first instance. Lenders will likely now be more disinclined to finance a retailer's bid for reorganization in light of the fact that a debtor must be positioned to pay in full at confirmation a class of claims traditionally entitled to no more than a discounted unsecured distribution. To the extent that lenders continue to refrain from providing postpetition financing, the benefits of section 503(b)(9) will rarely be reaped by trade creditors simply because retailers will be deprived of the requisite funding needed to attain administrative solvency at confirmation. To this end, trade creditors will not only fail to receive immediate payment on their 20-day claims, but such claims will not be paid by virtue of a debtor's inability to confirm a plan. As such, the "benefits" conferred upon trade creditors through new section 503(b)(9) may very well be illusory.

While it may still be too early to tell whether the Act truly rings the death knell for retail reorganization, the absence of a single retailer that has emerged from a Chapter 11 proceeding as a reorganized entity since the Act's inception in late 2005 is telling. Until such time as the Code is modified to improve a retailer's liquidity position in all phases of the reorganization process and once again whet the appetites of lenders to advance postpetition financing, we should expect to see a continued increase in the number of retail liquidations and a corresponding decrease in the number of retail reorganizations.

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## Executive Compensation Under Amendments to the Code

*Effect of law that seeks to limit bonuses and severance to insiders is difficult to predict*

BY MARK GROUPE  
AND HENRY D. BASH, JR.

**I**N 2005, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), one of the most sweeping amendments to the Bankruptcy Code since the Bankruptcy Code itself was enacted. From general such as plan flexibility to nonexempted real estate acquisition deadlines to providing credit counseling for individuals, the 2005 law could have a significant and lasting impact on cases filed after its effectiveness.

File of the most highly paid corporate executives in S&P500 in executive compensation in 2007. In the past 12 months, executive compensation is increasingly becoming a lightning rod for criticism, the premier chafe for all things bad in the business community. As he lectures Kevin Murphy, professor at the Marshall School of Business at the University of Southern California. "The average pay for chief executives of large companies in the S&P500 is \$10.5 million," says Murphy, estimated that the ratio of the average CEO's annual compensation to the average CEO's annual compensation was 1 to 36 in 1992, 1 to 43 in 1997, 1 to 53 in 2002, and 1 to 100 in 2007. The average CEO's annual compensation during 2007 was almost \$10.5 million, and a recent study of corporate directors reported that a majority of the compensation of the CEO's compensation is not commensurate with the company's performance.

**Mark Broudy** is a partner and **Henry P. Gass Jr.** is a senior associate in the Boston & Southwest, Inc. group, of Laibson & Walker, both located in the New York office. **Robert Richards** is former associate in the firm, involved in the prosecution of this matter.



phically answers from this trend. While increasing executive compensation is perhaps not as widespread in bankruptcy as it is outside the bankruptcy process, many debtors have sought to justify their increased compensation and bonuses for certain executives through "any employment-related progress" or "annual incentive plan." In fact, a board's ability to create for any compensation does stem through the prior review and approval of a Bankruptcy Court may in fact establish otherwise limited losses. Companies that go through executive bonuses for years while operating in the marketplace may suddenly identify a critical need to implement a vast bonus package (note to October 11).

However, the storm, as they say, may be blowing. Outside (bankruptcy) activist shareholders are starting to propose resolutions trying to force compromise to performance.<sup>1</sup> The Securities and Exchange Commission announced its review last week of the company's accounting practices. The disclosure of "total compensation" and of executive officer perquisites worth \$10,000 or more (Representative Barney Frank, now chair of the House Financial Services Committee, recently declared that "Congress must act to deal with the problem of excessive compensation that is now so common") by itself might escape the self-censorship of top executives, but it is clear that it significantly will affect management's compensation. The SEC will also review workings of the executive staff. Inevitably, copying will affect compensation during late second quarter of the Union affairs.

**New §503(c)**

Time to BAP, PA, Gonzales, and severance for management within the confines of Chapter 11 were considered "uses of estate property outside the ordinary course of business," and resulted

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### Revisions put prospects for postpetition financing in doubt

BY LAWRENCE C. GOTTLIEB  
AND NETH VAN AALTEN

*It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness,*  
—Charles Dickens,  
"A Tale of Two Cities"

**D**ICKENS' much-quoted line said about the French Revolution seems an apt description of the effects of the Biologics by Abuse Prevention and Consumer Protection Act of 2005, S. 254 (the act) on the suspension rights of certain creditors and debtors in retail Chapter 11 proceedings.

The act, which amends the U.S. Bankruptcy Code (the Code), was signed into law by President Clinton on September 8, 1993, although most of the provisions did not become effective until 10/1/96. While much of the publicly scrutinized act was focused on certain consumer and creditor abuse issues, the act also provides relief under Chapter 7 of the Code. The act contains a surprising number of provisions that significantly impact corporate insolvency issues, particularly those relating to the reorganization of debt.

Any effort to narrowly address the full impact of the act on the bottom of the Code provisions affecting retail debtors is doomed to fail. The changes triggered by the act are so broad in scope and extensive that only a com-

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preliminary review of this act would suffice. Accordingly, the scope of this article is well be limited to the act's implementation to, and introduction of, some of the more critical Code sections affecting a retailer's ability to meet its liquidity needs and of other necessary post-1981 financing—the liquidity to its successful retail re-organization effort. After such it is still far too early to tell whether the act truly signifies the "death" of retail reorganization, it seems fairly evident that the changes wrought by the act represent the "seizure of time" for retailers seeking to rehabilitate their businesses under Chapter 11 and the "death of time" for

Out

within existing constitutions, including utility providers, commercial banks and housing authorities.

### Postpetition Financing

liquidity is the likelihood of reorganization. Absent the ability to pay certain post-secured debts as they come due, including taxes owed, employees, vendors, common carriers, utility providers and estate payable debts to name just a few, the prospect of a mutual reorganization is little more than a pipe dream. Moreover, the question of whether these obligations can be met is rarely left to the discretion of the debtor. Most reorganizations contemplate a Chapter 11 filing having experienced sustained periods of liquidity problems and have relied on the secured lending community for access to cash pending their bankruptcy filing. Consequently,

business

at the commencement of each case, virtually all of a retailer's assets will be subject to the purportations of its creditors and may not be used or sold without their consent.

Lenders have duties both to protect the interests of creditors of their collateral and, just as important, to protect long-term financing interests of the firm by not exceeding the firm's capacity to effectively reorganize and thereby avoid any diminution to the value of their collateral. Lenders have little to gain from the Chapter 11 process unless the reorganization yields sufficient value to require the lender to give up its collateral. Lenders have no real incentive, in such a regime, and amount of outstanding assets in place. When a lender does not possess the requisite level of confidence in a given debtor prior to entering the Chapter 11 process, it will frequently forego a sale of the collateralized assets pursuant to §561(b)(3) of the Code and avoid the risk of any further diminution to the value of its collateral.

As discussed before, the act of announcements to the C-to-Es is a self-stilled perspective taking exercise. Announcements at the ground level and beyond. Now, restrictions on the advertiser's linguistic freedom are seemingly justified: the advertiser is potentially leading to even greater provoking postpositive biasing. For instance, now provisions expanding the universes of claims entitled to admission to the private treatment have created an atmosphere of doubt as to whether a retailer would possibly possess enough credence and a willingness to pay such claims to help a consumer to obtain the ideal breathing space of the so-called standard of care.

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# Trademark License Agreements

The rights of a debtor/licensee to assume, or assume and assign, are uncertain.

BY HENRY CONDELL  
AND PETER HARTUNG

**W**HEN A REPUTABLE trademark is used in connection with the sale of goods or services, the trademark owner is entitled to the right to control the use of the trademark. The trademark owner is also entitled to the right to control the use of the trademark in connection with the sale of goods or services.

Litigation addressing the "applicable law" question has resulted in divergent analyses and conflicting results from different state courts of appeals and lower courts. As a result, courts are unable to consistently predict the outcome of trademark license agreements as to the rights of the respective parties affected by the issue.

This article reviews the state of the law on this issue, and as it relates to the rights of a debtor/licensee to assume, or assume and assign, are uncertain.

## Assumption and Assignment

Section 365(f) of the Bankruptcy Code provides that "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of a particular type of real or personal property, whether or not the contract or lease is in the debtor's business, if the court determines that the assumption or rejection is in the best interests of the estate."

Under this provision, the trustee is not required to assume or reject any executory contract or unexpired lease of a particular type of real or personal property, whether or not the contract or lease is in the debtor's business, if the court determines that the assumption or rejection is in the best interests of the estate.

In *Bank of America v. 203rd Street*, the court held that the trustee is not required to assume or reject any executory contract or unexpired lease of a particular type of real or personal property, whether or not the contract or lease is in the debtor's business, if the court determines that the assumption or rejection is in the best interests of the estate.

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equity had intervened into trademark license agreement with the trustee of certain law-firm trademarks. The court held that NCP had no right to the law-firm marks since they were non-assignable as a matter of applicable trademark law. The court also held that the trustee could not assign the marks to NCP.

While noting the application of the "applicable law" question, the court found it was bound by Ninth Circuit precedent that had adopted the "applicable law" test. The court found that the trustee's right to the law-firm marks was not assignable as a matter of applicable trademark law.

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BY BRIAN S. HERMAN  
AND JUSTIN G. BRASS

**R**ECORDED COMPANIES have long despised the use of bankruptcy by recording artists seeking to resolve their record deals or to sign new ones with competing labels by rejecting their existing deals or threatening to do so. Such bankruptcy just got more appealing to these same record companies as a result of the Eleventh Circuit's recent decision in *Thompson v. Lake Records, Inc.*, et al.<sup>1</sup>

In *Thompson*, the Eleventh Circuit concluded that, through a bankruptcy of an artist's record company, the artist's copyrighted materials that were owned by the record company—i.e., recorded music, and related music publishing rights—could be sold by the record company free and clear of any obligation to pay the artist royalties for the latter's ongoing exploitation of the copyrighted materials.

We suspect it is antithetical to many in the music industry that the right to enjoin an artist's copyrighted materials to specific labels is deemed from the obligation to pay the artist royalties. And it is for that very reason that *Thompson*'s result is most and perhaps significantly to record labels and their artists.

#### The Facts in *Thompson*

In 1985, Jeffrey J. Thompson, a rap artist known as J.J. Money, signed a bankruptcy-exclusion recording agreement with the producers of Lake Records, Inc., an entity founded by a member of the South Florida-based rap group 2 Live Crew. Pursuant to the recording agreement, Thompson, among other things, conveyed to Lake Records "exclusive, unlimited and perpetual rights throughout the world" to the copyrights "in sound recordings (as distinguished from the musical compositions owned and controlled by Thompson) recorded by [Thompson] during [the term]."

In exchange, therefore, Lake Records agreed to pay Thompson royalties according to certain specific formulas. During the bankruptcy

of the contract, Thompson recorded three albums as part of the group called "2 Live Crew."

On March 28, 1995, after the terms of the recording agreement expired, an involuntary bankruptcy petition was filed under Chapter 7 of the Bankruptcy Code against Lake Records. The case was subsequently converted to Chapter 11 and (provisionally) consolidated with the Chapter 11 case of Lake Records' founder, Luther Campbell.

In March 1996, the bankruptcy court approved Lake Records' and Campbell's joint plan of reorganization. Pursuant to this plan, Lake Records sold certain specified assets, including "all worldwide rights to the music... owned or controlled by Luther Campbell or Lake Records' and Campbell's joint plan of reorganization."

Significantly, the assets, which included Lake Records' rights in and to the *Thompson* recordings, were sold free and clear of any and all liens, claims, encumbrances, charges, debts, or any other obligations of any kind, and, free and clear of any interest in such property of any entity other than Lake Records.<sup>2</sup>

The joint plan further provided that all necessary contracts that were not otherwise disposed of prior to confirmation of the plan were deemed assigned pursuant to 36U of the Bankruptcy Code. Lake Records' exclusive recording agreement with Thompson was among the contracts that were included.

Pursuant to the bankruptcy court's order approving the joint plan, counterparties to rejected contracts, including Thompson, were given 30 days to file a claim for damages in Lake Records' Chapter 11 case. Thompson never filed such a claim.

About six years later, on March 6, 2002, Thompson sued Lake Records, L.P. for both Music, Inc., and Soundgroup (collectively, "L.R.") in the U.S. District Court for the Northern District of Georgia for, among other things, copyright infringement or, alternatively, breach of contract.<sup>3</sup>

Specifically, Thompson asserted that, as a result of Lake Records' rejection of the exclusive recording agreement, about six years later, ownership of the copyrights for Thompson's recordings was transferred back to him, consequently, L.R.'s exploitation of those copyrights infringed on Thompson's rights therein.

## Recording Artists, Beware!



A recent ruling permits sale of copyrights free and clear of royalty obligations.

In the alternative, Thompson asserted that L.R.'s ownership of the copyrights brought with it an obligation to pay royalties to Thompson for L.R.'s ongoing exploitation of those copyrights. By failing to pay such royalties, Thompson asserted

that L.R. was in breach of its obligations to Thompson.

#### Eleventh Circuit Affirmed

The Eleventh Circuit affirmed the district court's summary judgment

most grant in favor of the defendants.

The court easily dismissed Thompson's first point—that copyright ownership reverted to him upon Lake Records' rejection of the recording agreement—because it was established that rejection, while a material breach, is not the functional equivalent of a reversion. Where property—here, copyrighted material—is acquired by a bankruptcy debtor pursuant to a prebankruptcy executory contract, rejection "does not divest the debtor to return the property."

What is more significant, though, is the Eleventh Circuit's ruling in *Thompson*'s second point—that it is not necessary to assume the consent of the copyright owner to the sale of the copyright. Here, the Eleventh Circuit held that in bankruptcy it is possible to sever the obligation to pay royalties from the ownership of the copyright.

This latter holding in this case stands in stark contrast to the Second Circuit's more cautious decision in *Fane v. Irving Trust Co.* (44 F.2d 884, 2d Cir. 1931).<sup>4</sup> However, in *Thompson*, the bankruptcy of a music publisher that, prior to its bankruptcy, had purchased from the plaintiffs various compositions including words and music, all of which were identical except as to melody and

the recorder for the bankruptcy music publisher sought to sell all of the music publisher's right, title and interest in the copyrights for the songs free from royalty claims.

The plaintiffs objected to any sale free and clear of their royalty rights, and sought an order directing the recorder to assign the copyrights to them, or, in the alternative, to sell the copyrights subject to the plaintiffs' continued right to receive royalties.

On appeal from the district court's decision to rescind the publishing contracts and rescind the copyrights to the plaintiffs, the Second Circuit ruled that a musician should usually consider bankruptcy as a means of maximizing value through a sale of the label's music, catalogues free and clear of claims for ongoing artist royalties, and credits.

Importantly, though, the Second Circuit held that "while the copyrights may be sold by the trustee, they should be sold subject to the right of the composer to have them worked in their label and to have paid royalties according to the terms of the contracts." In other words, the buyer of the copyrights would be required to work them and pay over to the

composer any royalties accruing after the sale.

Why the divergence between the Eleventh and Second Circuits? Because, according to the Eleventh Circuit, the court in *Whitman* was concerned that, unless the artist's royalty rights flowed with the copyrights, the artist would be deprived of the only means of compensation he had been promised.

In the Eleventh Circuit's view, what differs in *Thompson* is that the bankruptcy Code, which did not exist in the present form until 1978, with after *Whitman* was decided, expressly provides the artist with the right to assert a post-petition damage claim against the bankrupt recording company to recover future royalties. Thus, according to the Eleventh Circuit, the artist's concern is not left completely without recourse in the event that his original copyrights, transferred in consideration of future royalties, are later sold to a third party out of the debtor-assignee's estate, free and clear of royalty obligations due to the musician in his original copyright transfer/royalty agreement.

Unfortunately for Thompson, he did not assert himself of the right to file a damage claim.

#### Implications of Ruling

At least one implication of *Thompson* is obvious, and that is that recording artists must be vigilant in protecting their rights in the event their record label files for bankruptcy.

It is unclear from the Eleventh Circuit's decision whether such vigilance on the part of Thompson would have resulted in the outcome, however, at the very least, artists should be vigilant, certainly, the moment of their recording contract and, if it is rejected, file a claim for damages.

The implications of the *Thompson* decision on the record label's perspective can be summed up as follows:

(1) An artist label that suffers from financial distress and its creditors should carefully consider bankruptcy as a means of maximizing value through a sale of the label's music, catalogues free and clear of claims for ongoing artist royalties, and credits.

(2) An acquiror must bid to acquire and subsequently exploit copyrighted music free and clear of the obligation to pay royalties.

Of course, many record labels may be reluctant not to pay royalties and of course for artists or for acquirors on other practical

Continued on page 13

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Ms. SÁNCHEZ. We will now begin the questioning round, and I will begin by recognizing myself for 5 minutes.

Professor Westbrook, you indicated in your written statement that Wall Street held a chaotic private trading session for traders to settle or unwind their contracts with Lehman on the afternoon before Lehman filed for bankruptcy.

To the extent that this trading session occurred on the eve of the Lehman bankruptcy filing and may have been done with the knowledge that the bankruptcy was eminent, do you believe that there are issues that the Court ought to examine in connection with the private trading session?

Mr. WESTBROOK. That may well be true. I wasn't a fly on the wall, I am sorry to say. My information comes from the Wall Street Journal story on that private trading session. But it seems to me for sure Congress ought to find out what happens in a session like that where, because of the exemptions we have been discussing, all the rules about preferences and fraudulent conveyances are out the window when you are trading these kinds of financial assets.

Whether or not there may also be something that the Court in the Lehman's bankruptcy should take a look at, I don't know enough to answer that question. But I would start with an assumption that somebody ought to consider whether it is a good idea for the Court to take a look at it. That far I could go.

Ms. SÁNCHEZ. Thank you. The netting provisions that were added in 2005, largely at the urging of financial services—of the financial services industry and by the Federal Interagency Working Group, the argument at that time was unless counter parties were permitted to net out their provisions, one bankruptcy could have a ripple effect on the market with catastrophic results as a result of systemic risk. Do you believe that these amendments are having their intended effect?

Mr. WESTBROOK. I think the amendments, if anything, may increase the domino risk. Because what we have seen in the present crisis is that without the control, the orderly control that bankruptcy brings to these kinds of crises, you don't have a slow and careful liquidation maximizing value.

Frankly, one of the benefits, it is true that bankruptcy sometimes delays things too much, I give you that. But on the other hand, some delay is one of the benefits of bankruptcy. What we are seeing in the present crisis is a lot of collateral being thrown on the market at the same time. As a result, it declines in value. When sales are made at low prices, everyone else holding the same kind of asset has to mark down that asset, and then their balance sheets start looking bad and they may have to file bankruptcy. Part of the point of bankruptcy is that the government steps in in the form of the courts and imposes an orderly circumstance on the liquidation or reorganization of the company and the sale of the assets. So I think, if anything, the domino effect is exaggerated by these amendments.

Ms. SÁNCHEZ. Thank you. Professor Adler, as part of the 2005 amendments, the period in which a debtor had to assume or reject commercial leases was greatly shortened and the discretion of the Court to extend that period without the consent of the lessor was

taken away. This provision was added at the urging of the shopping center industry.

What impact has this change had on the ability of national retailers to organize successfully?

Mr. ADLER. I don't doubt, as Mr. Gottlieb suggests, that it has hindered reorganization of retailers. I don't know that it has hindered it quite as much as he suggests, because there is a good deal of discretion about when a debtor files for bankruptcy. Obviously, if a firm is illiquid or ill solvent, they can't wait forever.

But insolvency and default on debts don't typically fall out of the sky. Firms can see them coming, and one thing they can do is plan their bankruptcy. Before they file their bankruptcies, they can look at the various outlets that are subject to lease, decide which they are going to want to close, and decide which they want to remain open prior to filing for bankruptcy. So the 210-day limit that has been mentioned may not be quite as restrictive as has been suggested.

This also suggests that perhaps it is the economy and, as I mentioned, the fact that these retailers are in a weak condition that has led to the increase in their liquidations. As I mentioned in my testimony, Montgomery Ward was a dead business not because of the Bankruptcy Code, but because it had no customers and this was prior to the 2005 amendments and they lingered in bankruptcy for 2 years. They emerged from bankruptcy. They were reorganized, and then they closed all their stores a year later anyway.

What replaced those Montgomery Ward stores were Targets and Wal-Marts which were successful and which had employees and still have employees. The Montgomery Ward employees are all gone. I don't mean to dismiss the benefit of the Ward employees in this hypothetical or this illustration, I should say. I don't mean to dismiss the benefit of their having their jobs for 2 years. There is nothing more important. However—

Ms. SANCHEZ. So you think there is enough flexibility in the current system? I am just trying to get a brief answer because I have very little time left.

Mr. ADLER. I apologize. I believe there is significant flexibility, given that the debtor can plan to some extent when they file. Yes.

Ms. SANCHEZ. Mr. Gottlieb, I would ask for your sort of reaction to that, and if you could also add in ways in which we could perhaps change that provision to give retailers a better chance of emerging from Chapter 11 bankruptcy.

Mr. GOTTLIEB. Well, I guess it wouldn't be surprising that I disagree with Professor Adler in his response. My experience has been involved in cases such as Federated Department Stores, which took over 2 years to reorganize. But it did and they are still around. Macy's took over 2 years to reorganize. It did and it is still around. The amendments went into effect in October 2005. The economy was a bit healthier then. And as I stated in my remarks, only two retailers, to the best of my knowledge, that have filed since 2005 have reorganized. Before that time, retailers regularly reorganized; not all, and some failed, obviously. But clearly the empirical evidence would seem to indicate to me that they had a much better chance.

The idea that they can plan ahead of time and extend the 210 days really doesn't work for two reasons. Number one, debtors file Chapter 11 when they have to. They don't generally go to their attorneys a year ahead of time and say I have got to start planning for a Chapter 11. They file when the bank has called the loan when they've run out of liquidity, and it all happens very quickly, number one.

And number two, and most important, the banks have decided that when a debtor files, they just don't have enough time to let it try to reorganize. So when they file the loan at the beginning of the case, the dip loan at the beginning of every single one of these cases provides for a liquidation within 210 days. Whether they plan to assume those leases, whether they like these leases or not, the banks will not lend into a reorganization.

Ms. SÁNCHEZ. Thank you. I appreciate your response. My time has expired and I recognize Mr. Cannon for 5 minutes of questions.

Mr. CANNON. Thank you, Madam Chair. And I ask unanimous consent to include in the record the statement of Joyce Koons.\*

Ms. SÁNCHEZ. Without objection, so ordered.

Mr. CANNON. It seems to me, Mr. Gottlieb and Mr. Adler—in the first place, Mr. Adler, that was a very coherent statement that you made on the timing of the bankruptcy. And as I hear the two of you, Mr. Adler and Mr. Gottlieb, what we really have is a difference of view of the value of retail as institutions.

I think Mr. Adler would suggest that, hey, if they can't make it, they can't make it, and let's get somebody else in those leases in those outlets in those malls. And, of course, Mr. Gottlieb, this is not a question. There is a balance here between the interests of the owners of malls and rental space and retail organizations when it comes to how we balance the interest in bankruptcy, is there not? Isn't there a difference?

I mean, these people are—some people—the people that have invested in bricks and mortar want that to be productive with a new tenant and their neighbors. The other stores next door to them actually want them to be productive with new tenants.

Mr. GOTTLIEB. I understand that. I agree with that, actually. The thing is, though, that during the Chapter 11, the landlords have to be paid on time. In fact, they normally have to be paid even more on time than was the case before the Chapter 11s.

What we have talking about are landlords getting paid their rent that they've negotiated with their the debtors in Chapter 11. If the retailer has more than 210 days to live, the landlord still has to get paid. So as long as they are getting the benefit of their bargain for those leases, I don't know why they should be in a position to decide that Chapter 11s should fail.

I would also add one other thing. It will be interesting, I think, to speak to the landlords in 6 months to a year, the mall owners in 6 months to a year, after all these retailers fail, the economy is as it is now, and they are going to have vacancies. It will interesting to see when you bring them before this Committee whether or not they might be willing at this point to permit there to be

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\*The statement of Joyce Koons had not been received by the Subcommittee at the time of the printing of this hearing.



some discretion in the Bankruptcy Court to extend that time to let retailers survive.

Mr. CANNON. There may be. The benefit of the bargain, though, includes other things than just the rent payment. Often there is a percentage of sales, and clearly the other stores around it have a benefit from a vibrant operation as opposed to a dying operation. I think that we would agree on that, wouldn't we? You would agree with me on that?

Mr. GOTTLIEB. I would agree with that also, and I think it is a balance of interest.

Mr. CANNON. Right. Exactly. Mr. Adler, you appear to have something you would like to say.

Mr. ADLER. Yeah. If the lessors are unhappy with how quickly things are moving, even under the current law, they can consent to allow the lease to continue. This is a right that they have to have a decision on assumption or rejection occur quickly, in part because they want to protect the malls, as you say. Many of these leases are in malls. An anchor store in particular has effects on neighboring stores, some of which will close down if we have a dying enterprise allowed to extend for long periods of time.

But in response to Mr. Gottlieb, if the lessors are unhappy with the quick decisions, they have it within their power under the current law, as I say, to change that simply by permitting an extended decision.

Mr. CANNON. Thank you. I appreciate the insights because this has been very good testimony. We worked intensively on this issue beforehand and I hope that we will continue to look to see how—we are going to have to learn something about how it works over time. And the fact that we are interested in a difficult economic environment now is probably not the best time to make decisions but, rather, to see how it works through a cycle in the future.

Thank you for that.

Mr. Westbrook—Professor, I should say—one of the things I gave up in my life to become a Congressman was my very pleasant association with Jones Day, which is a great law firm. I love it.

For the remainder of my time, I would like to have you talk just a little bit more about the transactions that are happening here based upon your earlier testimony and how the bankruptcy law affects those in particulars, because we are looking here now at this big revamp of the whole system or at least a bailout. Who knows what we are going to call it? But making liquidity available.

And it would be interesting to hear what kind of instruments are sitting around that are going to be paid for or made liquid with Federal money and how those—how that is affecting, for instance, Lehman. I mean, this had to be a fairly significant decision by the Secretary of the Treasury not to rescue Lehman, given the context of bankruptcy and what was going to be liquid or not liquid or what pressures were going to come to bear on Lehman.

If you would give us a little insight on that, I would appreciate that.

Mr. WESTBROOK. Certainly. I will do the best I can. We still have relatively little information about Lehman's because it happened so recently and it is so enormous, as the Chair pointed out earlier. What we can say is that a very substantial portion of the assets

of Lehman's consisted of these exempted sorts of assets, and those assets essentially went out the door either shortly before bankruptcy or shortly after bankruptcy because of the lack of application of the automatic stay, of the avoiding powers, and of things like the ipso facto provisions that say you can't cancel a contract because someone is calling it a bankruptcy. That doesn't apply with respect to these kinds of financial contracts.

So as a result, we know that an awful lot of Lehman's assets, I can't put a number sitting here today—but an awful lot of Lehman's assets were simply disposed of privately. Contracts were terminated. One obligation maybe on a credit derivative was liquidated against another obligation secured by mortgage-backed securities, things that have nothing to do with each other, because of the expansion of the master netting provisions in 2005.

So what we can be sure of is that a lot of value that might have been available either to try to reorganize Lehman's or at least to liquidate it in a way that would maximize value was instead permitted to be liquidated, walked away with, if you will, by the counter parties to all of those transactions. I wish I could give you more specifics.

If we talked again in 2 or 3 months I suspect we could, because I am very interested in Lehman's and I plan to find out what my old friend Harvey Miller is doing over there with that company.

But I will say this. It is striking that in Lehman's, the biggest assets, as far as I can see, other than these exempted assets, were the going concern value of its broker-dealer operations in the U.S., the U.K., and Japan. All of that has been sold for something like \$5 billion or less. It is hard to tell from the exact figure from the reports. Frankly, \$5 billion is walking-around money in Lehman's case, whereas it was noted the debts are over \$6 billion. So it is hard to know what else is left there for anybody.

Unsecured creditors, including more than 150—it is even hard to say the word—billion dollars' worth of bonds, unsecured bonds, I have to assume, unless we hear something quite startling, are going to get little or nothing out of that Chapter 11. So there is going to be a dramatically unequal distribution of value, a dramatic lack of sharing of the pain among the creditors of Lehman's. But I can't put numbers on it. Forgive me for that.

Mr. CANNON. Thank you. And I see my time has expired. Madam Chair, I yield back.

Ms. SANCHEZ. The gentleman yields back. At this time, I would recognize the gentlelady from California, Ms. Lofgren, for 5 minutes.

Ms. LOFGREN. Thank you, Madam Chairwoman. And I would like to ask Professor Westbrook on this Lehman private session—and I don't want to make accusations because we don't know what happened. I mean, we have a press account, so let me just posit it as "what if" without being accusatory. What if the private session were as described in the press? Are there adequate tools available to the Bankruptcy Court via fraud statutes to unwind things that were done in that session, in your judgment?

Mr. WESTBROOK. The answer is no. The reason, ma'am, is that the normal avoiding powers, as we call them, preference and fraudulent conveyance law in bankruptcy, are specifically among the

things that—from which these financial assets are exempt. So I think the answer to that is no. There might be some State law that could be applied, but my sense is that couldn't be applied in the bankruptcy; it might be applied separately under State law. The reason we have those provisions in bankruptcy law, they don't work very well when they have to be applied by individual creditors under State law. So I think in terms of adequacy and in most cases even in an attempt to be able to do it at all, gosh, that the answer to your question is no.

Ms. LOFGREN. Mr. Adler looks like he is anxious to comment.

Mr. ADLER. Yeah. Thank you. Professor Westbrook is right that the fraudulent conveyance provisions of the Bankruptcy Code are called off in these netting of derivatives. But fraudulent conveyance of the bankruptcy law is a term of art having to do with transfers for—typically having to do with transfers for less than real value. I think if anything happened at this session, it was an honest to God fraud, crime, deceit, tort. I don't think the special provisions of 2005 would prevent liability from being visited upon anyone who committed such tort or fraud.

Ms. LOFGREN. I am interested—obviously, we are here looking at Lehman as the topic, but we have got sort of the elephant in the room on what is going on in our economy generally. Since we have got three professors who know a lot, I am just going to take the opportunity to ask the broader question, which is what to do in the face of the current economic challenges.

We have had a proposal made by the Secretary of the Treasury and Mr. Bernanke and the President that has been refined for more oversight and the like. One of the things that is not included is a provision that would permit individual homeowners facing foreclosure to renegotiate their loans and save their homes in bankruptcy, because that is in many cases the only way—the only forum where it actually can be done.

I am concerned—I mean, people have different views about bankruptcy and the like. But just on a practical level, if we are unable to deal with the individual homeowner facing foreclosure, in your judgment will we be back here with an additional crisis a year from now or the like, if we don't allow for that steep decline in housing to be arrested in some fashion?

Mr. WESTBROOK. I have two responses to that, if I may. The first one is I think that could be the case. That is, I think this problem needs to be solved from the bottom up, as well as from the top down. And I think if you solve it, either one or the other is not going to be enough.

The second point is this. Much of the discussion, quite correctly, has focused on the difficulty of having a Federal program that deals with a million foreclosures, each in local areas, different and so forth and so on. The benefit it seems to me of doing something about this provision that prevents what we call lien stripping or adjustment of value for primary residences—and it is the only exception. Every other kind of secured debt—well, now certainly automobiles, but—

Ms. LOFGREN. Taxes and student loans, too.

Mr. WESTBROOK. Right. But every other secured debt can be adjusted in terms of the value of the collateral. What we have is 300

bankruptcy judges around the United States who are experts in doing this. A Federal system actually exists, remarkably enough, for dealing with each of these individual problems if Congress will, forgive the expression, unleash the Bankruptcy Courts to do what I think is a necessary job.

Now, I don't think that is a complete answer because some of these folks perhaps shouldn't go into bankruptcy in order to sort out a mortgage problem, particularly if they were lied to or whatever. But for many of them, it is probably the only lifeline as a practical matter that you in this building can give to many of these homeowners, and it would work because we have the people in place to do it and they know how to do it.

Mr. ADLER. I think the matter is somewhat complicated. I think anyone would agree that when a bank is holding a mortgage on someone who can't pay it in full and properly that can't satisfy the loan in full, it is in everyone's interests for them to reassess and renegotiate the loan so that payments are manageable and will give the bank the highest possible return. And we could all be happy if that were easy. The problem is it is not. It is not clear that cram-down is the way to do it. It might be better if negotiation directly were possible.

One thing we are all discussing prior to this hearing is that part of the problem with the fact that these loans have been packaged and sold, the originator of the loan no longer owns them, so it is difficult to know who should be doing the negotiation and thus cram-down is a plausible response, not necessarily the best one.

I do want to add that I think we should be careful not to think that it would necessarily be a good thing to reinflate the housing bubble by propping up prices if there is no real value in those properties anymore.

Ms. LOFGREN. I know my time has expired, Madam Chair, but I ask unanimous consent for an additional minute.

Ms. SANCHEZ. Without objection.

Ms. LOFGREN. Property values are going to decline. I mean, that is going to happen. That is happening. So the question is not whether we are going to inflate a bubble. That is off the table. The question is, can we put a floor on a collapse, because as the inventory increases through these foreclosures, the entire market is going down and it is a spiral down, and we have gotten some information that over half of the foreclosed properties have a second. You can't get the second to agree to a renegotiated price. Plus, since all of the mortgages have been securitized and sold off, you can't even get the authority to do a renegotiation, which is—not that I love bankruptcy, but you need to have somebody with the authority to make a deal. And that is in the interests of actually everybody.

Mr. ADLER. Congresswoman, I agree completely that that is the fundamental problem. It is not clear whether that can be solved better by forcing these people into bankruptcy and cram-down. But I entirely agree.

Ms. LOFGREN. The only thing I would add is that we have maybe a couple of days to figure it out.

Mr. ADLER. You do have a couple of days, though. You have to have the bailout by noon, so—

Ms. LOFGREN. A system that works versus something that, theoretically, if we had a couple of years, we could figure out.

Mr. WESTBROOK. Let me just say if I may, Congresswoman, that it is possible that you could do something on a temporary basis. I mean, that happened a lot back in the thirties. Oh, I don't like to invoke that. But nonetheless, a lot of things were put in for 2 or 3 years.

Ms. LOFGREN. If I may, in the thirties, my grandparents had a little house that they built, and they were able to negotiate an interest-only payment because the bank had so many properties, they didn't want another property. But the difference there is they had a bank they could deal with. You can't make that today. I don't want to abuse the Chair's—

Mr. CANNON. May I ask unanimous consent that the gentlelady be granted 2 more minutes, because I would like to follow up on this.

Ms. SÁNCHEZ. Without objection, so ordered.

Mr. CANNON. Ms. Lofgren and I have been working on this issue, trying to figure out where we go. And I would like to ask another question similar to what she has asked. You have this complicated environment, seconds and fractured or fractionated interest, and it is very difficult—I mean, you know, we were talking earlier about how does the Secretary of the Treasury resolve these problems without it taking—because you have got—any person who says I don't like the fact that you reworked that mortgage then has a taking and the claim for a taking among the many problems that happen if the Treasury has the authority to do this.

On the other hand, we are in this very difficult environment and according to the Mortgage Banking Association, 80 percent of the subprime loans are performing. Of the 20 percent that aren't, half are being worked out. Of those half that have been worked out, the rest are being worked on in a way that will keep people in their homes, meaning you have got 10 percent of the subprimes, which means a much smaller percentage of all the loans outstanding are now troubled and need the kind of resolution that Ms. Lofgren is talking about.

Is it worth opening up, even in a limited sense as you—because we were talking about limiting it by time or limiting it by nature of the loan, and both have problems. But is it worth opening that door to anybody, say, from 3 or 4 years ago, who got a loan for another year, giving them the opportunity to go into bankruptcy? Or do we open up so many—the opportunity for so many people to come in and get relief that it becomes vastly counterproductive. And that is the question I think we are asking, and I would love to hear your views on that.

Ms. SÁNCHEZ. Who are you posing the question to?

Mr. CANNON. I think principally Professor Adler and Professor Westbrook.

Ms. SÁNCHEZ. Okay. I am going to ask that you answer as briefly as possible. We have just been summoned to votes. And in all fairness, I would like to give Mr. Delahunt an opportunity to ask his 5 minutes of questions. So if you can briefly answer Mr. Cannon's question.

Mr. ADLER. I think the Congressman puts his finger exactly on the problem. On the one hand, you don't want to induce the entire segment of the mortgage population into bankruptcy when it might be able to work out their mortgages outside of it. Nor do you want to favor, necessarily, those who are nonperforming on their mortgages as opposed to those who are dutifully paying it, which is why I think this cram-down provision would be problematic.

Mr. WESTBROOK. Just very briefly. I've seen very different figures, Congressman, on how many voluntary workouts there are. I will give you at least some other sources of information on that subject. My sense is that the voluntary workouts are not working nearly that well. And also the problem extends way beyond subprime loans. And the Alt-A loans are in big trouble, even subprimes. I think it is a bigger problem.

Mr. CANNON. We don't have a couple of days on this. If you can communicate with our staff and get some source information, that would be helpful.

Ms. LOFGREN. If I may. Like today would be helpful.

Mr. WESTBROOK. I will do my best.

Ms. SÁNCHEZ. The gentlelady's time has expired.

Mr. DELAHUNT. I thank the Chair. And I would commend the Chair. I think it is interesting, here we are in the midst of a huge meltdown and where is everybody? Because these are absolutely essential questions to address, and I would hope that while we are here you continue to have these informative hearings.

I would like to talk about the business reorganization, because I was on this Subcommittee when we went through bankruptcy reform. And we gave it very short shrift. And I appreciate what you are saying.

It was, I think, Professor Westbrook that said we have 300 bankruptcy judges out there. You, Professor Adler, talked about discretion in terms of planning when to file. I don't buy into that for the reasons that Mr. Gottlieb indicated. I believe in discretion, however. And I believe in discretion to those that do this professionally, such as our bankruptcy judges. I am not talking—this is really conceptual, if you will. I think we have got to give them a lot more leeway to make commonsense decisions in terms of what is happening in our economy today, particularly among, you know, Chapter 11 reorganizations.

Any quick comments from either one of you?

Mr. ADLER. A lot of bankruptcies are filed exactly 92 days after a payment has been made, which forces the payment outside of the preference period. So that is evidence of some planning. There is some planning.

Mr. DELAHUNT. I am not saying it doesn't exist. I am suggesting planning with the intent not to play a game or to game the system, but planning to make a sincere and genuine effort to sustain, you know, a viable, a potentially viable corporation.

Mr. ADLER. There is no doubt that there are limits. I am not suggesting that the planning is infinite, the planning opportunity is infinite. And there is a trade-off. The easier you make it for firms to reorganize, the more likely you are going to save good firms but the more likely you are going to save bad firms along with it. And the question is whether or not society is better off—

Mr. DELAHUNT. But my point, Professor Adler, is that is why I vested in the bankruptcy judge to make those decisions. I mean if there is anyone that should be cognizant of who is gaming what here, I would hope it would be the bankruptcy judge. Mr. Gottlieb?

Mr. GOTTLIEB. Yeah, I would like to respond also. I think first again, remember, as I stated, the problem is that even if you plan ahead of time as to which leases you like or you don't like, the point of fact is that the banks are unwilling to fund reorganizations no matter how you plan ahead. They walk in and they want to make sure their collateral is liquidated within 210 days, in the stores and not on the streets.

In addition to that, I would suggest, and I think as you suggested, when the business bankruptcy provisions were put into this bill it was put into this big consumer bill.

Mr. DELAHUNT. Right.

Mr. GOTTLIEB. And I think a lot of them were probably done quickly.

Mr. DELAHUNT. You are being kind.

Mr. GOTTLIEB. And what didn't happen—

Mr. DELAHUNT. They were done without any—minimal thought and analysis. That is the honest response.

Mr. GOTTLIEB. Right. So you had individual provisions that were lobbied for, and I understand the lobby—

Mr. DELAHUNT. Correct.

Mr. GOTTLIEB [continuing]. But no one, I suspect, looked at all those provisions together as one unit and said how will this affect business bankruptcies? The way they protected it is they have drained liquidity—

Mr. DELAHUNT. The Bankruptcy Reform Act was driven by the credit card industry. Everybody understands that.

Professor Westbrook, and this is just an observation to all of you, you are very informative, and I appreciate the tutorial that you are providing us, but you have got to change your language. You cannot presume that any of us know what netting means. You can't—what is the other word? Netting. Give me—

Mr. GOTTLIEB. Exemptions.

Mr. DELAHUNT. Exemptions. Don't make those presumptions. I happen to have an understanding of them, but it is not just for Members of this Committee, but when you are here you have a chance to begin to participate in educating the American people. Sometimes, even though there is no one here, they will run this thing on, you know, at 3 a.m. some Sunday. It is important that we all participate with a better understanding of what is out there. Nobody knows what is out there. And your language has to be clear so that the average citizen, okay, now I understand it, now I get it. Netting, you can come here, you can talk about, we can talk about swaps and derivatives, it ain't working.

Ms. SÁNCHEZ. The time of the gentleman has expired. And I want to thank all of the witnesses for their testimony today.

Without objection, Members will have 5 legislative days to submit any additional written questions, which we will then forward to you and ask that you respond to as quickly as possible so that we can make those a part of the record. And as I understand, there

is also great interest in getting additional information even more quickly than 5 days from now.

Without objection, the record will remain open for 5 legislative days for the submission of any additional written materials. And, again, I want to thank the witnesses for their time and their patience in putting up with our crazy voting schedule. And with that, the hearing of the Subcommittee on Commercial and Administrative Law is adjourned.

[Whereupon, at 11:29 p.m., the Subcommittee was adjourned.]



## A P P E N D I X

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MATERIAL SUBMITTED FOR THE HEARING RECORD

LETTER FROM KAPPA ALPHA PSI FEDERAL CREDIT UNION (KAPFCU),  
DATED SEPTEMBER 26, 2008

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Chairman/President

William Whitehead  
Chief Financial Officer

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Kenny Henderson  
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Dwight H. Hamilton

**Kappa Alpha Psi  
Federal Credit Union**

**New Accounts  
Administrator**



**Kappa Alpha Psi Federal Credit Union**

P.O. Box 703047,  
Dallas, TX 75370  
(972) 394-3324-Direct Line  
Email: VRussell@kapfcu.org

September 26, 2008

Honorable Chairman John Conyers, II  
House Judiciary Committee  
2426 Rayburn H.O.B.  
Washington, D.C. 20515

Re: \$700B Treasury Secretary Paulson's Plan

We have assessed several reasonable solutions in addition to Secretary Paulson's presentation for the \$700B. The amount of money that is being requested is not being distributed in the most financially productive matter.

Albeit the amount is correct, our position is that the flow of capital should be directed and invested into the mortgagor. Those that have experienced this nightmare of a problem over these past years. There are two to three million homes that are and have yet to come through the foreclosure processes. At an average \$150k mortgage, \$700B would satisfy up to 4.6 million mortgages.

Investing the taxpayer's money into individuals by eliminating their most onerous debt obligation, irrespective of whose misjudgment will provide significant flexible in respect to growing this economy. Relieving these families of their most unprofitable liability, will immediately allow them to purchase goods and services that ordinarily they would not have the sustainability to invest and/or manage their households.

Keeping families in homes and stabilizing on average the most important asset that Americans typically invest in our neighborhoods, would be in our government's best interest. Any city experiencing more foreclosures and abandoned homes only deteriorates the value of those that are working hard to retain their respective investments in their primary real estate holdings.

*Financial benefits for Kappa Psi, their families, and associations*

NCUA

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A more unilateral distribution of our taxpayers money would be to channel the flow of this \$700B investment, from the bottom up than investing it into tranches that no one can physically see the collateral associated with the investment. The Bush Administration and Secretary Paulson would have you believe that there is a mathematical measure to formulating a value to acquire real estates and securities that you can not see. It is impossible to use this type of a formula knowing that there is the potential of no floor to this theory.

If we are thinking that \$700B is the absolute amount required to invest under this computation, at the end of the day the number could conceivably be another trillion dollars before the government tries produce a solution to this mess. Betting on the unexpected "mark to market" value of securities can produce a zero sum value before you ever turn a profit, hence ballooning into an unpredictable dollar amount.

Working with the consumer in forming this "bail out" plan will take care of two immediate problems. First you have positioned a family to be much more productive and the flow of this capital / investment will go directly to the mortgagee. The later of the two will be self sufficient in curing the balance sheet of these institutions, which is the intent of the Treasury Paulson's plan.

There can be all type of criteria and deed restrictions that the Treasury can put on these assets as they invest the taxpayers dollars. Those homeowners that have their primary residence are the only ones that will qualify under this plan. Taking over pools of securities that are in comingled funds and clearing the balance sheets of these institutions is like, supplying more alcohol to and alcoholic.

Alternatively, if the Treasury would look at these same retail assets, given "any" level of foreclosure, on a prorated base the Treasury could pay down a minimum of 35% of a families principal mortgage balance. Simultaneously stabilizing the homeowner and provide a HUD insured SPC to facilitate a new 40 year first lien mortgage. Each of the mortgages would have a deed restriction relative to a holding period of 10 years and at such

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time that the home is sold, the 35% percent would be repaid to the Treasury. All the time through the ten-year period, taxpayers would be receiving interest income from the new 40-year first mortgage under this KAPFCU plan.

In summation, working from the bottom up and placing the economics of this county in the hands of those most likely to continue to spend on "general" services as a daily routine, is a much better investment of capital. The idea of building a base and working "up" is much more cost efficient alternative than "top" down spending and no one can qualify the end results without gambling away the future of America.

Sincerely Yours,

Victor F. Russell  
Chairman of the Board / President

*"Financial benefits for Kappa Psi, their families, and associations"*

NCUA

RESPONSE TO POST-HEARING QUESTIONS FROM JAY WESTBROOK, ESQ.,  
PROFESSOR, UNIVERSITY OF TEXAS SCHOOL OF LAW, AUSTIN, TX

Jay L. Westbrook

Response to Questions:

(Please see bold highlighted answers below)

**QUESTIONS FOR PROFESSOR JAY WESTBROOK.**

1. You indicate in your written statement that Wall Street held a chaotic private trading session for traders to settle or unwind their contracts with Lehman on the afternoon before Lehman filed for bankruptcy.

To the extent that this trading session occurred on the eve of Lehman's bankruptcy filing and may have been done with the knowledge that Lehman's bankruptcy was imminent, do you believe that there are issues the court ought to examine in connection with that private trading session?

**Yes, I do. Not enough is known about those sessions to reveal what was done and whether it was unfairly prejudicial to anyone. It may not have been. But historically the period just before bankruptcy has often been used to advantage some creditors over others. I would expect a trustee in bankruptcy to examine these events, but in Lehman so far there is only an examiner. I think the examiner's role should include investigating this matter.**

2. Although it is still early in the case, could you discuss the potential impact of provisions allowing for the exemptions and netting provisions added by the 2005 amendments to the Bankruptcy Code on the Lehman case and how they might impact similar cases in the future?

**Here also, the greatest problem is lack of public knowledge of the events and their impact. I understand that Lehman's may have been involved in around 1.5 million transactions with thousands of counterparties, most of which were terminated very quickly. Those terminations would be especially serious as to a) liquidation of valuable collateral without court control and thus a risk of loss of value; and b) termination as of the petition date of contracts "in the money" for Lehman, a second category of loss of value for its creditors.<sup>1</sup>**

3. The netting provisions were added in 2005 largely at the urging of the financial services industry and by an federal interagency working group. The argument at the time was that, unless counter-parties were permitted to net out their positions, one bankruptcy could have a ripple

<sup>1</sup> Jeffrey McCracken, "Lehman's Chaotic Bankruptcy Filing Destroyed Billions in Value," Wall St. J. (Dec. 29, 2008) ("As much as \$75 billion of Lehman Brothers Holdings Inc. value was destroyed by the unplanned and chaotic form of the firm's bankruptcy filing in September, according to an internal analysis by the company's restructuring advisers.").

effect in the market with catastrophic results as a result of systemic risk. Do you believe that these amendments are having their intended effect?

**We have no data. The classic model is that uncontrolled and uncoordinated liquidation of collateral leads to fire sales, which lower value for the seller and for all the other sellers in the market as well, tending to drive whole markets lower. I suspect that may have happened here.**

4. To what extent did these exemption and netting provisions may have provided a false sense of security to derivatives traders, and do you believe that this might have contributed to the reckless conduct that has contributed to the current financial crisis?

**I do not have information on this point.**

5. As we consider a bailout package for Wall Street, many of us in Congress have raised concerns about the President's proposal. Chief among these are the need for greater transparency and accountability, the need to avoid conflicts of interest and self-dealing, and the need to restrict excessive executive compensation. The Bankruptcy Code already provides for all these things when dealing with the insolvent institutions like Lehman. Do you think some of these other institutions could work out their financial difficulties in bankruptcy without having a Federal government bailout? What should Congress take away from current bankruptcy practice that might assist us in crafting protections for taxpayers as we consider the administration's proposal?

**We already have special liquidation procedures for banks and insurance companies, but they do not cover the various new types of financial or quasi-financial institutions that have arisen in recent years nor investment banks that until recently did not play such direct and market-oriented role in the capital markets. These changes reflect the fact that much of the capital available in the last two decades has come from public markets without being intermediated by traditional financial institutions in the traditional ways. We need to define a new class or classes of financial institutions and provide special procedures for them, either as part of the existing bank liquidation schemes or through special Bankruptcy Code provisions like those for broker-dealers. At the same time, we need to eliminate broad exemptions for financial instruments and focus any necessary exemptions in relationship to ongoing market and institutional regulation.**

6. In bankruptcy, we have the absolute priority rule, which requires that creditors be paid ahead of equity security holders. The President's proposal appears to stand this rule on its head. Do you have any thoughts on the relevance of the absolute priority rule to this situation?

**Except as a strictly limited and focused emergency measure, I cannot support subsidization of equity holders of insolvent institutions. Please see below.**

7. As you are well aware, the Lehman Brothers bankruptcy filing is the largest in U.S. history. After the sale of most of Lehman's assets to Barclays, how do you expect the remainder of their Chapter 11 reorganization to proceed?

**Slowly. It is a massive job and will break new ground in a variety of ways.**

8. If a bailout package similar to the legislation currently under consideration today is enacted, how would it impact the solvency of financial institutions that have amassed huge losses in risky mortgage-backed securities, and other collateralized debt obligations?

**Since the time I testified, it has become apparent that even those massive sums were not enough to make all the major institutions solvent. Following the "stress tests," some of them should be seized and their assets sold, with the government liquidating the assets over time to realize maximum value. The government may have to provide temporary support to those institutions that are salvageable, but should get much better terms than in the first round to protect the taxpayers. Until we clear out the insolvent banks and shore up the rest, so we are able to declare the remaining banks whole, the credit markets cannot revive. Even the stimulus package will not revive the real economy without reviving credit markets. It may be necessary for the government to honor obligations beyond the FDIC guarantee to depositors to avoid the effects we saw from the disastrous decision to let Lehman fail without government intervention. To honor those additional obligations will be very expensive, but it may well be necessary for the largest institutions. Finally, the whole process must be made more transparent along the lines suggested by the Congressional Oversight Panel.**

9. Do you think a \$700 billion bailout would insulate financial services corporations from having to file for bankruptcy in the near future?

**I think the total will be much higher.**

10. Did the broadened exemptions and netting provisions have any role in the current financial crisis?

**I think so, but I cannot do more than that until we have data. The lack of regulation ex ante and the lack of transparency in the interventions to date mean the Congress cannot properly assess what has happened.**

11. If Lehman has secured assets, does Bankruptcy Code section 506 allow the secured claim to be bifurcated into an allowed secured claim and an unsecured claim? Do you see any reason why a Chapter 13 debtor should not be able to do the same with his or her home mortgage?

**No. While that change will not solve the entire problem, it will help considerably. Almost all of the cost to lenders has already occurred, although it is not surprising that they are reluctant to concede that reality. The government has 300 highly trained and experienced officials--bankruptcy judges--to handle equitable and necessary mortgage adjustments. It should let them get to work on this part of the foreclosure crisis.**

12. Would cramdown in Chapter 13 make getting mortgages more difficult for homeowners?

**There is no evidence that it would. For example, second homes have never been subjected to the restriction, but there is no reason to think their availability or rates have been affected by the possibility of cramdown.**

13. Did Chapter 12 have the sort of deleterious effect on farmers we are being warned would hit homeowners if we allowed cramdown?

**The studies indicate it has not.**

14. If Senator John McCain were to file for bankruptcy today, of his seven homes, how many would he be permitted to cramdown?

**Six.**


15. My constituents who have only one home, would they be able to save that one home using cramdown? How about a steel plant? Could Sen. McCain modify the loan on his private jet in bankruptcy?

**All of the collateral mentioned would be subject to cramdown except your constituents' homes.**

Respectfully,

Jay L. Westbrook

February 22, 2009





RESPONSE TO POST-HEARING QUESTIONS FROM BARRY E. ADLER, ESQ.,  
PROFESSOR, NEW YORK UNIVERSITY SCHOOL OF LAW, NEW YORK, NY

NEW YORK UNIVERSITY  
SCHOOL OF LAW

January 9, 2009

Honorable Linda T. Sanchez  
Chair, Subcommittee on Commercial  
and Administrative Law  
Congress of the United States  
House Committee on the Judiciary

Dear Congresswoman Sanchez:

Following my testimony in September, you submitted to me four written questions, which are attached to this letter. My numbered responses to these questions are provided below:

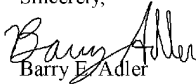
1. While Chapter 11 may have failed to rehabilitate retail chains that have recently liquidated in bankruptcy, this is not necessarily a failure of the bankruptcy process. The reorganization provisions of the bankruptcy code are designed to facilitate the survival of economically healthy firms, not of all firms that file for bankruptcy. The retail chains that liquidated, like many businesses that liquidate in bankruptcy, may not have been merely financially distressed, but economically inviable. In this case, liquidation is a solution, not a problem. Quick liquidation can yield a fast, efficient redeployment of assets and new jobs as a result.
2. As suggested by my prior response, I don't believe that there is necessarily a problem with Chapter 11 merely because many firms liquidate rather than reorganize. Instead, one might argue that a problem with Chapter 11 is that it still inhibits liquidation in some cases where that is the appropriate outcome. For example, it is difficult or impossible for a debtor at the time of borrowing to opt out of bankruptcy's automatic stay, which keeps creditors from seizing assets after a debtor petitions for relief. The bankruptcy code should be more flexible and permit debtors and creditors to reach any contractual arrangement they desire. This might mean a quick end to some firms, after they have failed, because bankruptcy would not protect them from their creditors, but there might be cheaper credit, and consequently greater job creation, for debtors earlier, when they seek finance.
3. The shorter period that a retailer in bankruptcy now has to assume or reject a commercial lease absent the consent of the lessor may well lead to increased liquidations. But as my prior answers suggest, this is not necessarily a problem.
4. The increased rate of bankruptcy filings tells us that the economy has left many firms unable to meet their debt obligations, which were issued in expectation of

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better times. This is a natural course of debt finance, however, and I'm not sure the increase tells us much of anything about Chapter 11.

I hope that these responses are helpful. Please do not hesitate to inquire further if you have additional questions. It was an honor to testify before your committee.

Sincerely,

  
Barry E. Adler  
Professor of Law

**Response to Post-Hearing Questions from Lawrence Gottlieb**

1. You indicate in your written testimony that retailers who enter the Chapter 11 process have little hope of emerging successfully.

What specific reforms to Chapter 11 do you recommend so that retailers will be able to successfully reorganize?

1. I believe that the most important modification should be to Section 365(d)(4). I will discuss what specific modification should be made in response to your Question 2.

2. Section 366 should be modified to permit adequate assurance for utilities to include arrangements other than cash deposits.

3. Section 503(b)(9) should be amended so that vendors receive a priority claim for goods sold to a debtor within 10-15 days. The key difference here is that a priority claim, as opposed to an administrative claim which is what current Section 503(b)(9) provides, need, not be paid in full at the time of confirmation. A priority claim must be paid in full, but the payment may be stretched over time.

2. In your testimony, you cite the nonresidential leasehold provision that was amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 as particularly problematic for retailers.

How could this provision be changed to give retailers a better chance of emerging from Chapter 11 bankruptcy?

There are two key modifications to Section 365(b)(4) which should be made:

1. The Bankruptcy Judge should have discretion to extend the debtor's time to assume or reject a lease. One size clearly does not fit all. There may be very distinct differences to be considered when dealing with a retailer that has hundreds of leases as opposed to a retailer with very few leases.

2. The Bankruptcy Judge should be able to extend the time for a debtor to assume or reject leases if circumstances are in favor of such an extension. The number of extensions should not be limited. However, the amount of time for each extension, as a compromise with the shopping center owners (the "Owner(s)"), should probably be limited to 4-5 months. I would also agree that the debtor should have the burden to justify the extension. The Owners

would then have an opportunity to regularly state its case to limit the extensions. Lenders would not have to necessarily be concerned that the debtor would lose its leases so fast. If the debtor needs extra time to assume a lease, it could ask for an extension sufficiently prior to the expiration of the last extension, to enable the lenders to know there will be added time within which to run a liquidation sale.

3. The broader credit crunch is very much on everyone's minds right now. We have received reports, especially over the last year, that DIP financing has become much more difficult to obtain, over and above the reasons you cite in your testimony.

What has been your experience?

I have little doubt that DIP financing for retailers literally has become impossible to obtain except to enable the debtor to sell its assets pursuant to a Section 363 sale or a liquidating going-out-of-business sale. Indeed, GE recently announced that it would not provide any DIP financing until 2009, at the earliest. I know that other lenders, such as CIT, previously withdrew from that market.

4. Organizations such as the International Council of Shopping Centers argue that prior to 2005, solvent businesses were increasingly taking advantage of Chapter 11 "to accomplish goals that would otherwise not be permissible, such as shedding leases they determined had become undesirable."

What is your response?

I believe that the International Council of Shopping Centers' position is based upon one incorrect assumption. The purpose of the US Bankruptcy laws is to enable a debtor to attempt to rehabilitate itself and to have a fresh start. One of the key items almost always present in a restructuring of a retailer is the elimination of the non-profitable locations. If Congress were to accept the landlord's argument, then it would be next to impossible, even in a healthy economic environment, for a retailer to successfully reorganize.

5. Shopping center owners assert that retailers under the bankruptcy law prior to 2005 caused them to lose control of their properties and caused neighboring tenants to lose business. In sum, they assert that this purported abuse of the system "hurt entire local economies."

What is your response?

I fail to understand how shopping center owners indicate that the prior Bankruptcy law caused them to lose control of their properties and caused neighboring tenant to lose business. Under the prior Bankruptcy Code, debtors were still required to pay the rent and additional rent timely. The

bargain that the landlord makes when it enters into a lease is that the tenant shall pay rent payments and additional rent timely. As to neighboring tenants losing business, it is an overstatement to suggest that tenants lose business in a mall in which one of the stores is in Chapter 11. In some instances, that may be true and in other instances that may not be true. The shopping center may have other weak tenants that are not in Chapter 11. I think even the landlords would agree that they have no power to force a premature termination of the lease as long as the tenant, whether it be strong or weak, is paying the rent. It turns the rationale for Chapter 11 on its head if Chapter 11 gives the Owners the right to make it more difficult for tenants to survive just because they file Chapter 11.

6. The shopping center owners believe that "most debtors engage in pre-bankruptcy planning before initiating a case, which includes analyzing their lease portfolio, and, therefore, have a basis for making decisions on which leases to keep or jettison when they file for bankruptcy protection," and that therefore the 2005 Amendments are beneficial for both retailers and landlords.

What is your response?

The issues that the Owners avoid when they state the position described in Question 6 is that the 2005 amendments prevent retailers from reorganizing whether or not they have successfully analyzed their lease portfolios before filing Chapter 11. The 210-day absolute immutable limit, has caused lenders to require the Chapter 11 retailer to sell the company or liquidate all its assets before the expiration of the 210 days. It doesn't matter whether or not the debtor has analyzed its leases. The lenders are just totally unwilling to risk the 210-day arriving and the debtor losing its leases before the lenders have had an opportunity to run a going-out-of-business sale. The lenders, as my experience has demonstrated, have absolutely no desire to permit the retailer to reorganize whether or not it has carefully analyzed its lease portfolio.

7. Prof. Adler reports a story told by Prof. Todd Zywicki, who was a frequent witness before this Committee, and one of the few academic advocates for the 2005 amendments, about the ill-effects of a Montgomery Ward store near his home remaining open for an extended period of time during the pendency of the case.

Do you have any thoughts about the problems described by proponents of the shopping center amendment to the Code, and how Congress might have addressed them in some other way?

I am sorry, but I do not understand the point of this question. If you provide me details about this Montgomery Ward store, then I would be happy to respond. As to how Congress might have addressed these problems, I think the proposal that I have outlined in Question 2, is a fair compromise. I would agree with the landlords that some judges might have gone too far by granting extensions of time to assume or reject leases for very large periods of time, such as until confirmation of a plan. The proposal I have put forth enables the Owners to periodically and regularly present its case that a delay in the debtor's decision on leases causes unacceptable harm to the Owners. The compromise I suggest is a fair balance between the public policy of Chapter 11 giving a debtor a chance to reorganize and the Owner's desire to control its property.